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(Continued inside cover)

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TAX POLICY IN A DEMOCRATIC SOCIETY

WALTER J. BLUM *

A FUNDAMENTAL PROBLEM for a society with democratic representative government is making a proper use of experts in public affairs. This raises the question what is a desirable and workable allocation of roles between specialists in public matters and ordinary citizens without such specialized training. The problem has grown in importance as increasing areas of knowledge have been more fully developed by individuals specializing in the particular fields. The more dramatic and recent facets of the problem are now being actively discussed. There is, for example, considerable interest displayed in the functions to be assigned to the nuclear scientist in the control of atomic energy and to the psychologist in the treatment of lawbreakers. But many of the older and less sensational aspects of the problem, which no longer attract wide interest, have neither disappeared nor diminished in significance for our society. Among the foremost of these is the part to be entrusted to economists in the formulation of public finance policies of the national government.

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FUNCTIONS OF EXPERTS AND OF CITIZENS

One dimension of public finance which affords a good point of departure for reviewing the proper function of economists as experts is tax policy. Taxation is selected for this purpose largely because of the manner in which we shall inquire into the role to be reserved to economists in the determination of policy. The procedure consists of blocking out the issues raised by economists in connection with tax policy which can be discussed reasonably by persons who have received a truly liberal education but no extensive training in economics. This is done by scrutinizing the analyses of various economists with a view to isolating the questions they deal with and then estimating which ones are, or are not, within the competence of the liberally educated citizen. For convenience, the findings of economists which appear to be beyond that measure of ordinary understanding are referred to as " technical " conclusions, while those within it are termed " political " judgments. In other words, a political

judgment is one which a liberally educated citizen is in a position to reasonably criticize or make; a technical conclusion cannot be reached or scrutinized without specialized training in the subject.

It is recognized that the approach adopted has several shortcomings and entails a few critical assumptions which are not explored. First, it is largely unrealistic to delve into monetary and fiscal theories from the vantage point of tax policy. Doubtless there is less distortion of emphasis if the competing theories are viewed broadly as comprehensive plans of action rather than as adjuncts to tax policies. But the use of taxation as a focal center supplies a means of making the inquiry more manageable and does not impair the results. Second, there is no definite and fast line between technical conclusions and political judgments. It seems more reasonable to assume that the work of economists involves operations which form a continuous scale ranging from the highly technical to the very common. Nevertheless, the general outlines of a division between those which are too technical for the liberally educated citizen and those which are not can be staked out. Third, the concept of a liberally educated citizen is left undefined. Because of my background I prefer to think of him as being typified by a graduate of a good law school, but other models will serve as well.[1] Fourth, it is presumed that the liberally educated citizen is interested in participating in the determination of tax policy. Possibly such citizens need politically be interested only in electing effective representatives. But if that is the case, it is presumed that the representatives are the citizens who are both liberally trained and interested in tax policy. Fifth, it is assumed that all decisions on public affairs which are within the competence of liberally educated citizens should be retained within their jurisdiction and should under no circumstances be turned over to the control of experts. Only by such a course can the full potentialities of education through self-government be achieved, the expansive tendency of the power of the expert over others be held in check, and the likelihood of bad decisions arising because of the limited vista before each specialist be avoided.

Our approach also draws upon a working hypothesis which it seems advisable to state explicitly. On more technical questions economists are more likely to be in substantial agreement among themselves; while on less technical issues they are less likely to be in accord. The foundation for this principle has a double basis. One is that unless there were fairly general agreement on the technical components of the subject, economics would hardly rate being treated as an organized body of specialized knowledge. The other is that economists are citizens, having the privilege and usually the propensity of making political judgments. It is

1 This remark suggests another difficulty not investigated in the article. It is conceivable that, in demonstrating a certain matter is not within the exclusive competence of economists, we shall be showing only that other kinds of specialists in public affairs are able to get into the act. I neither believe this is a realistic view of public affairs nor mean to illustrate it in referring to graduates of law schools. The lawyer may be an expert in various areas, but I do not regard him as being a specialist in the economic aspects of tax policy. When he delves into that subject I view him as acting in the capacity of a citizen with, I hope, a liberal education.

not unreasonable to suppose that in this capacity they will be moved by about the same range of factors as other citizens. In any event, the points of disagreement among economists provide keys for separating out particular questions to which they have addressed themselves. And, if our hypothesis is sound, the differences will tend to mark the political character of the judgments underlying the divergent positions.

Economists might be expected to furnish technical information on at least two broad questions which are relevant in the determination of national tax policy. First, they might be expected to describe the impact of different kinds of taxes on the productivity of the society. Here the economist would be considering the relationship of taxes to the long-run or secular economic progress of the country. Second, they might be expected to indicate the effects of alternative tax policies upon the stability or instability of the economy and the intensity with which resources are employed. In this the economist would be analyzing the bearing of alternative tax programs upon inflation and deflation and the trade cycle. The fact is that economists have had much to say, both of a technical and a political flavor, on each of these two questions.[2]

ECONOMIC PROGRESS

In regard to economic progress or productivity it is fairly simple to disentangle the expert conclusions and political judgments of the economists. It is probable that all economists would agree that at some point an increase in the rates of a progressive personal income tax would tend to reduce the amount saved by individuals, discourage personal effort (labor), and dampen investment in enterprises. At the present stage of economic knowledge, they probably also would concur that the retarding influence of such an increase in rates could not be measured and that it is not certain at what rate levels the discouragement would be significant. It is possible that they might disagree whether

[2] In keeping with the theme being developed, I feel it is unnecessary to draw upon the works of a large number of economists. Instead I selected six economists to be representative of all economists as specialists. Those chosen are associated with fairly definite positions on monetary and fiscal policies. The six, along with references to where statements of their positions—especially those on tax policy—can be found, are:

Milton Friedman: "A Monetary and Fiscal Framework for Economic Stability," *American Economic Review*, XXXVIII (1938), 245;

Harley L. Lutz: "Are Taxes for Revenue Obsolete?" *The Tax Review*, VII (April, 1946); "The Effects of Taxation," *The Tax Review*, VI (April, 1945); "Some Errors and Fallacies of Taxation as Exemplified by the Federal Income Tax," National Tax Association, *Proceedings* of the 34th Annual Conference (1941), pp. 371-373;

Alvin H. Hansen: "Stability and Expansion," in Twentieth Century Fund, *Financing American Prosperity* (1945), pp. 206-226; *Fiscal Policy and Business Cycles* (1941), especially pp. 179-182, 292-294, 298-299;

Seymour E. Harris: "Taxation and Full Employment," National Tax Association, *Proceedings* of the 39th Annual Conference (1946), pp. 243-245;

Lloyd W. Mints: "Monetary Policy," part of a Symposium on Fiscal and Monetary Policy, *Review of Economic Statistics*, XXVII (February, 1946), 60-68;

Henry C. Simons: *Personal Income Taxation* (1938), pp. 22-27; "Hansen on Fiscal Policy," *Journal of Political Economy*, L (April, 1942), 171-178; "Some Reflections on Syndicalism," *Journal of Political Economy*, LII (March, 1944), 19.

The foregoing references contain only skeletal and fragmentary statements of the positions of their authors on fiscal and monetary policies. They are cited to serve as a basis for investigating the positions more fully. In the main the references emphasize the tax policy aspects of fiscal and monetary policies.

the economist's tools can, in view of their nature, ever yield positive information about these matters. Nevertheless, even Henry C. Simons and Harley L. Lutz, who generally are as far apart as the poles, would agree that a progressive personal income tax is more adverse to economic progress than a sales tax or a proportional income tax which raises an equal amount of revenue. Thereupon the concord immediately ends. Lutz is led to the position that a progressive personal income tax is to be shunned while Simons is not deterred from endorsing such a tax enthusiastically. Their difference in this connection obviously is not to be explained by any technical analysis of the impact of various taxes upon economic progress. Both rather are making political judgments which take into consideration their common economic analysis. In effect, Lutz is deciding that the disadvantageous effects of a progressive income tax on economic progress (and perhaps on other aspects of the society) are strong enough to rule it out as sound tax policy. Simons, to the contrary, expressly recognizes that he is making the political judgment or stating the "persuasion" that, despite the retarding effects of the tax, it ought to be supported because (and this is another political judgment following an economic analysis) it is the least disturbing means of reducing economic inequality (which he finds "unlovely") in a private enterprise society.

There is no doubt that the liberally educated citizen is fully qualified to participate meaningfully in this debate between Simons and Lutz. He can do so without being acquainted with economic terms and methods. The technical conclusions of Lutz and Simons on the impact of a personal income tax upon economic growth can be accepted. The political issue can then be restated in nontechnical terms. Specifically, the issue here is whether the citizen prefers a society that is likely to be more productive in the aggregate but which contains larger inequalities of wealth and income, or one that is likely to be less productive but in which there is a greater degree of economic equality. In arriving at a decision the citizen might be aided if he were better acquainted with technical conclusions on related economic matters. It might be important, for instance, to be advised about the economic impact of alternative methods of reducing inequalities in the society. It might also be helpful to have estimates of the magnitude of change in the rate of progress likely to accompany the adoption of a particular structure of progressive taxes. But, after all the expert data have been assembled, there is nothing about the basic issue which puts it beyond the competence of the liberally educated citizen.

ECONOMIC STABILITY

Turning to the relationship of tax policy to economic stability, the citizen might on initial impression feel that the economists are speaking far above his comprehension. However, he should immediately perceive that various economists are proposing vastly different tax programs for the purpose of increasing economic stability. Harley L. Lutz recommends a sales tax or a proportional income tax. Alvin H. Hansen advocates shifting the emphasis from more deflationary taxes (such as a sales tax or a tax on wages) to less deflationary taxes (such as a progressive personal income tax) when it appears that there will be

a fall from a high plane of employment, and vice versa when it appears that an inflation is in the offing. Henry C. Simons, Lloyd W. Mints, and Milton Friedman counsel that a progressive income tax be maintained at all times regardless of fluctuations in the level of trade activity. These extreme differences among the experts should put the citizen more at ease. They should lead him to believe either that economists have no special knowledge which can illuminate this subject (which of course is not the case) or that some political judgments are mixed in with their technical economic analyses.

Despite the huge gulfs separating the recommendations of economists in this matter, there are a number of important points of agreement. Most of these are easily located. All economists probably would agree that a high level of employment can be reached or maintained only if there is a sufficient aggregate amount of spending in the economy. This observation merely states the almost self-explanatory proposition that if there is not enough spending there will be insufficient demand for goods and services to attract production in magnitudes that will bring about or sustain a high level of employment. All economists probably would agree that all varieties of taxes reduce the amount of spending in the private sector of the economy. This proposition perhaps should be qualified to the extent that a tax exclusively on "idle savings" or "hoards" conceivably might not cause such a reduction. However, no one has yet devised this kind of tax, and even if perfected it would be in the nature of a penalty rather than a true tax or revenue measure. Its objective, in other words, would be to prevent "idle savings," and if it succeeded completely in doing so, no revenue would be collected under it. There is another point on which all economists apparently would be in accord. It is always more deflationary to finance the government out of revenues collected through taxation than to operate with a deficit and pay for government expenditures by printing money, borrowing from the public, or paying the banking system to create money for the government. On all these points of agreement the liberally educated citizen might find that his general training was inadequate for him to understand and assimilate the analysis. But he would have no reason to doubt the validity of the conclusions; there is nothing in his background which should prompt him to reject the concord of the specialists.

Deficit Financing

The first sign of disagreement among the economists on the matter of taxation and economic stability concerns the advisability of ever operating the Federal Government at a deficit. Here the cleavage is a highly lopsided one. Lutz and his group stand virtually alone in advocating that the Federal budget be strictly balanced each fiscal year; all the others agree that at times it may be advisable to incur a deficit. The manner in which Lutz reaches his conclusion can be restated in a simple fashion: The aggregate of income received in the society is divided between that portion which is spent by the recipients and that portion which is saved by them. If all productive factors were completely mobile and there were no economic restraints of any kind, an amount equal to the saved portion would always be invested

—that is, spent—immediately by business enterprises. Thus all income would be spent currently either by consumers or enterprises and there would be no "idle" or "excess" savings in the society. The constant exact equivalence between aggregate income and aggregate spending would constitute a balance that would maintain a continuous high level of employment. Taxation would merely transfer to the government money which otherwise would have been spent by consumers or enterprises. If the government spent precisely the sum it collected by taxes, the balance of income and spending would remain undisturbed. A government deficit, on the contrary, would be an unsettling factor because it potentially would increase aggregate spending beyond the theretofore prevailing aggregate income. In brief, the deficit would destroy stability by being actually or potentially inflationary. It would inject additional money into the economy.

The other groups of economists have objected to this reasoning of Lutz on two grounds which are fairly technical. They concur that, given complete mobility of economic factors, savings and investment would tend to remain in balance, but they point out that this demonstrates only that an existing level of employment would remain constant. There is nothing in the analysis which leads to Lutz's conclusion that the level of employment would be a high one. His series of propositions are equally valid for intense utilization and for widespread unemployment of resources. The other economists also find no basis for accepting the position that unimpeded mobility of productive resources would be accompanied by an invariable exact equivalence between savings and investment. They agree that in a frictionless economic environment there would be at work forces which tend to bring about such an equilibrium. But they conclude that deviations from the equilibrium would be possible and these movements might assume significant proportions before the corrective forces became effective. If either of these two objections to the Lutz analysis is valid the underpinnings for his annually balanced budget plan are gone.

The educated citizen very likely could not comprehend the rather technical controversy whether savings would equal investment in a hypothetical society. But this inability does not preclude him from weighing the Lutz recommendation that the Federal budget be rigidly balanced each year. Alternative or complementary approaches to evaluating the recommendation are open to him. He reasonably can assume that the savings-equals-investment proposition should be ignored because all other groups of economists conclude it is either incorrect or meaningless. The props for the ever-balanced budget would then have disappeared. Or instead, or in addition, he can accept the premise that savings equals investment in an economic fairyland, but note that that region is too unlike our own society to serve as a testing ground for our tax policy. More specifically the citizen can call attention to his own observations that all productive factors can never be fully mobile; that some inflexibility is bound to exist in a society having large corporations, labor unions, and long-term contracts; that in the past when government budgets remained in balance the economy suffered serious depressions; and that it is too dangerous politically and socially to risk large de-

clines in trade while the government stands idly by and merely concentrates on making certain that its own budget is in balance. Surely these approaches permit the liberally educated citizen to join argument with Lutz on general political rather than technical economic grounds. The issues here are typically political.

Timing of Action

The second sign of disagreement among economists in regard to taxation and economic stability concerns the standard for determining when the government should take action to inject additional money into the economy.[3] Those experts who disagree with Lutz and maintain that at times the government should operate at a deficit disagree among themselves as to what gauge should be employed for deciding when the injection of money, by way of deficit operations or otherwise, is to be administered. Hansen and other advocates of budgets hand-tailored for prosperity urge that full employment (meaning a low degree of unemployment) of manpower should be the standard. They would have the government turn on the money stimulus as soon as there were indications that employment was about to fall from a satisfactory level. Simons and Mints object vigorously to that standard and contend for using a price level index in its place. They would commence injecting additional money as soon as the price index fell below a predetermined point. Friedman, while obviously more sympathetic with the price index than the full employment standard, proposes an even more automatic guide. He would, in advance, so arrange the revenue collections and expenditures of the government that an introduction of additional money through a deficit would automatically occur as soon as the national income fell below a predetermined satisfactory level.

How can the educated citizen participate in this controversy? There is no doubt that full employment of manpower initially impresses one as being an attractive and proper goal for society. Simons, Mints, and Friedman, in their capacity as citizens, agree that it would be very nice indeed if we could have full employment at all times without giving up anything. They are not objecting to the full employment standard because they wish the economy to have less than full employment. They object to using it as a standard for fiscal policy because they conclude that doing so would result in great instability and ultimately cause a collapse of our economic and political systems. A problem is thus set before the citizen. He must decide whether, in view of the warning that the full employment standard entails dangers of an alarming magnitude, it ought to be rejected despite its obvious attractiveness.

Simons and Mints argue that there are several dangers inherent in the full employment standard. First, they contend that, at the present state of human development, no one possesses the implements or the ability to make accurate

[3] I am concentrating upon the standard for determining when to inject additional money into the system and partially ignoring the standard for deciding when to remove money from the economy. The two standards of course form closely interrelated parts of the monetary and fiscal structure. For purposes of this article it seems advisable to emphasize the standard for monetary expansion because the positions of the economists appear to be farther apart and more fully stated than those dealing with the standard for monetary contraction.

forecasts of future economic conditions. The citizen is unlikely to know whether or not some specialists are able to anticipate economic developments; but he can reasonably form an opinion when he learns that the experts in national budget projections have been far below the mark just about as often as they have been far above it. This fact hardly should reassure him concerning the economist's capacity to predict successfully. Second, Simons and Mints contend that bad guessing about the future would aggravate the instability of the economy if the guesses were translated into action. Inflations and deflations both would be more severe if the forces causing them were augmented by those set in motion to implement the erroneous predictions. This is a point which the citizen should be able to understand. Third, Simons and Mints argue that if the country were to rely on national budget projections or other forecasts in determining monetary and fiscal policies, inexpert citizens—including those in Congress—would have to abdicate the function of formulating policies in this field. Concededly only an expert could make the projections, and those lacking the requisite specialized training could only stand on the sidelines. No doubt many citizens might welcome being told that the burden can no longer be theirs and that the matter has been entrusted to recognized experts. But such an attitude underlines the danger. The fact that forecasting economists have so often disagreed with each other in their guesses should be somewhat disconcerting to those who find comfort in living under expert guidance. Of even greater importance, however, is the obvious proposition that at some point democracy and representative government cease when basic policy-making functions are entrusted to experts and take a form which only the experts purport to comprehend. It is not too trivial to note that the spokesmen who advance these arguments are themselves members of the class of experts whose power in public affairs they would restrict. Fourth, Simons and Mints urge that, so long as substantial monopolistic practices or immobilities of productive factors exist, uninterrupted full employment can be had only at the price of continuous inflation—which is always likely to get out of hand. Inflation produces a redistribution of wealth and income which may be unwanted, and a wild inflation results in a breakdown of the monetary and credit system without which the productive machine cannot operate at even a moderate pace. This last conclusion may be difficult for the citizen to handle. He probably is not in a position to analyze whether maintenance of full employment under existing conditions would produce continuous inflation, or whether continued gentle inflation is likely to get out of hand. But, at the very least, he can appreciate some or most of the dangers and disadvantages of both a mild and a wild inflation.

The difficulty confronting the educated citizen at this juncture is complicated in that Hansen and the advocates of full-employment budgets do not concur that maintenance of full employment runs the danger of bringing about continuous inflation. Their position is that, given assurances of full employment, business enterprises and labor unions will be amenable to giving

up (or at least be more willing to suspend) their monopolistic positions and restrictive practices. This proposition has a negative implication which might furnish the citizen with a clue as to how he can participate in the controversy. The Hansen group imply that if the monopolies and restrictions are continued unabated in strength, the maintenance of full employment will be accompanied by some inflationary tendencies—although not necessarily of serious proportions. One important issue thus is whether an assurance of continuous full employment will so favor the elimination or lessening of monopolies and restrictions that it is reasonable to take a chance on a mild inflation and on its not turning into a severe one. This is the kind of judgment which the liberally educated person can make; perhaps he is apt to be more objective and realistic than the economist who has some preconceived views on the subject.

The citizen ought also to look at the positive position advanced by Simons and Mints before forming an opinion about the standard for determining when to start injecting additional money into the economy. Essentially it is that monetary expansion should be employed only as a means of preserving the stability of the price level. Such stability, the pair maintain, will have a double advantage. Private enterprise will be willing to undertake risks—that is, produce—if assured that there will be neither substantial inflations (price level increases) nor deflations (price level decreases). There will be definite rules of the game, which can be established on the basis of political judgments, and within which the experts in monetary affairs can operate. This will place the basic political decisions in the hands of the public and its representatives and relegate the experts to roles which are of a technical and less discretionary nature. Relieved of responsibility for basic policy decisions, the monetary experts will be in a position to concentrate on improving and using their professional know-how; unlike experts entrusted with discretion as to underlying policy, they will have no need of seeking ways to avoid exercising their responsibility in order to escape blame for error in judgment.

The response of Hansen and the advocates of full-employment budgets to the stable money school of economists might be anticipated. In general it is that price level stability is all right, but it will not insure full employment and it possibly or inevitably will result in periodic or even constant unemployment of undesirable proportions. The problem of what results to expect from price stability probably is too technical to be within the competence of the liberally educated individual. But there is a way around this obstacle. Simons and Mints would have to agree with Hansen that, given monopolies and restrictions of varying intensities, price level stability would at times be accompanied by considerable unemployment, although they might not agree that it would be great enough to be cause for serious alarm. Once this is recognized the critical question can be reframed. The experts themselves acknowledge that there are possible shortcomings and dangers in both the stable money and full employment standards. They differ on the magnitude and proximity of the risks involved in each.

Accordingly, the ultimate question here is whether the full employment standard, with all its possible drawbacks, is to be preferred to the price-level-stability standard with all its possible drawbacks. With the question so put, the educated citizen need feel no hesitation in entering what patently is a political controversy.

The difference between the standard for governing monetary operations advocated by Simons and Mints and that recommended by Friedman is rather easily detected. Simons and Mints would establish legislative norms—lower and upper limits within which the price level would be permitted to fluctuate—and then employ monetary experts to maintain those limits. Some leeway would be left to the specialists in the selection of methods and techniques of functioning inside the statutory limits. Friedman, on the other hand, would attempt to set up in advance a sort of automatic pilot mechanism: once established, no room would be left for corrective human judgment. This would be arranged by two measures. One is gearing the tax structure and tax rates to balance the regular Federal budget at a level of national income corresponding to reasonably full employment at a predetermined price level. The other is fixing in advance the qualifications and rates for unemployment relief payments (which transfer payments would not to be treated in the regular Federal budget as expenditures). If these two components were established on a prudent basis at the outset, according to Friedman the economic system would tend to remain in balance near the level selected. The ultimate point at issue between Friedman and Simons or Mints is whether the society will make use of its human judgments in advance, as a political matter, and thereafter exclude the experts entirely; or whether the society will be satisfied to set up certain rules of the game in advance and allow the experts to function within them. The educated citizen should enjoy discussing this question.

Methods of Injecting Money

A third area of disagreement among economists regarding taxation and economic stability concerns the manner of injecting additional money into the economic system.[4] Those who agree that at times such an injection is advisable differ not only on the standard for determining when it is advisable but also on the best means of arranging for it. Hansen and Seymour E. Harris counsel that monetary expansion be accomplished by increasing government expenditures for public works to be financed by borrowing. Presumably part of the loan would be obtained from individuals; but the bulk would be procured by borrowing from the banking system which would create new money in the process. Simons and Mints advocate that the expansion be effectuated by open-market operations to pay off part of the Federal debt in new government money created for that purpose; and by holding governmental expenditures fairly constant, reducing tax collections, and printing added quantities of new government money to pay for expenditures not covered by the reduced tax receipts.

[4] As in the case of standards for controlling monetary expansion and contraction, I am focusing attention on the manner of injecting money into the system rather than on the manner of removing it. The reason for this emphasis is stated in footnote 3.

Friedman recommends that the expansion be arranged by maintaining regular governmental expenditures—including those for public works—constant, allowing tax collections to fall automatically (without a change in rates) as a result of the contraction in incomes accompanying a deflation, and increasing government transfer payments in the form of unemployment assistance. The terms and rates of such compensation would be established in advance, and an increase in total transfer payments would occur automatically as unemployment increased. This composite of vectors would produce a government deficit in a period of deflation, and the excess of outlay over intake would be covered by the new money thereby introduced into the economy.

The differences which lie behind these diverse programs stand out rather sharply when the supporting statements of the proponents are compared. Hansen favors public works as a vehicle for monetary expansion because of two principal factors. First, public works are highly expansionary, he states, in that all money used to pay for them is spent at least once. An equal amount of added money put into circulation by reducing taxes without curtailing expenditures, or by making government transfer payments, or by buying in part of the Federal debt is less expansionary since some of the added money might not be spent at least once in the immediate time period. Second, public works, he asserts, are desirable for their own sake. According to Hansen, they create additional opportunities for investment in private enterprise, insure maintenance or expansion of our aggregate capital plant, and in themselves are useful and beneficial to society. Harris adds that public works benefit the class of persons society wishes to benefit, while tax reduction or tax remission fortuitously presents bonuses to those who happen to have taxable income or other taxable capacity. Simons and Mints join issue squarely with the views of Hansen on public expenditures. Simons emphasizes that widespread indulgence in public works for the purpose of causing a monetary expansion will produce an atmosphere inimical to private investment. The private sector of the economy, he maintains, is bound to contract in the uncongenial environment of government competition. Moreover, spending through public works to counteract deflation is not conducive to responsible government. Logrolling will inevitably accompany an indiscriminate selection of projects. To avoid these undesirable features, Simons and Mints urge that public works be undertaken only on their merits and never as pipe lines for routing added money into the economy. In other words, the public or its representatives ought to decide what activities the government is to perform by comparing the specific benefit to be derived from the projects with the burden of the additional taxes required to pay for them; and all other spending in the society should be entrusted to the private sector of the economy. There is an important assumption in this position. The stable money advocates admit that the increase in private spending stimulated by a given amount of government deficit created through tax reduction or debt retirement or transfer payments may not be as expansionary as the same

amount of deficit created by augmented expenditure for public works. But they assume that private spending can be boosted enough by those means to maintain both stability and a satisfactory level of activity in the economy.

The educated citizen should be quick to realize that the crucial judgments which underlie the foregoing views of Hansen and Harris or Simons and Mints are political in nature. He should feel at ease discussing whether widespread public works are incompatible with a vigorous private enterprise economy; whether consumers and businessmen are likely to increase their spending if taxes are reduced, or if government bonds are exchanged for money, or if large transfer payments are made; whether extensive appropriations for public works are more vulnerable to abuse than the printing of additional money; and whether it is more desirable to have the government spend money to create a deficit than to stimulate consumers and businessmen to spend more. These questions, which no doubt in part impinge upon technical economic analysis, surely are not exclusively within the special preserve of the economist.

Another major difference which lies behind the cleavage between Hansen and Simons on financing a montary expansion concerns the use to be made of the government's power to borrow. Hansen assumes a continuation of the present type of borrowing, with a variety of short-term and long-term securities, which are sold to individuals, institutions, and commercial banks. Simons insists that government borrowing should take the form only of issuance of long-term securities—preferably consols or perpetuities—and that commercial banks should be required to hold reserves equal to their deposit liabilities so that they cannot expand the money supply by making loans to government or business. Under these conditions, government borrowing would be a method of absorbing purchasing power and curbing a dangerous inflation. Simons regards present methods of borrowing by sale of securities to commercial banks in order to finance a monetary expansion as an unsatisfactory substitute for the government's printing additional money. Such borrowing, he argues, weakens the effectiveness of debt policy and impairs the defenses against drastic inflation. Furthermore, borrowing creates an interest-bearing Federal debt, while the issuance of additional money does not. A growing Federal debt, Simons believes, runs the awful danger that those who own no bonds may some day rebel against the payment of enormous sums of interest to bondholders. Such a revolution would almost certainly bring an end to the existing political and economic order. Hansen, on the other hand, is not worried about a large and expanding Federal debt. So long as the national income is expanding at least as rapidly as the debt, the interest payments on the debt, he asserts, will not grow more burdensome. He is not concerned with the ability to borrow to stem an inflation, apparently because he does not view the possibility of a runaway inflation as a real threat under his program. Nor is he troubled that the debt will grow to an unreasonably large size. There is rather an overtone of an opposite sort. Hansen apparently in part advocates borrowing because he believes Congress would be more inclined to borrow a given amount to stimulate spending than to authorize the printing of an

equivalent amount of additional money.

Once again it seems clear that the liberally trained person should not feel excluded from discussing these political judgments on which the experts are erecting their programs. The fact is that citizens and their representatives for years have expressed themselves on whether a large and growing Federal debt is dangerous and whether the legislature ought to borrow or create new money. These same issues are at the root of the split between Hansen and Simons on the means of producing a monetary expansion.

CONCLUSION

An important guide to action emerges from this analysis of what the economists have said about tax policy. Technical economic analysis can sharpen the basic issues and assist in tracing through the implications of alternative lines of action. But the fundamental questions themselves are still political: they are issues which liberally educated citizens can grasp, discuss, and resolve.

FEDERAL CORPORATE INCOME TAX—REVENUE AND REFORM

LOUIS SHERE *

IN HIS BUDGET message for the fiscal year 1950, the President forecast Federal deficits of $0.6 billion in the fiscal year 1949 and of $0.9 billion in the fiscal year 1950. These deficits are in sharp contrast with the large surplus of $8.4 billion in fiscal year 1948. The surplus in the cash budget, which is more significant than the ordinary budget for purposes of economic analysis, was expected to decline from $8.8 billion in fiscal year 1948 to $2.8 billion in fiscal 1949 and to $1.5 billion in fiscal 1950. The budget message frankly stated that certain items, such as military aid to foreign governments, had not been included in the expenditure estimates.

Anticipating budget deficits and continued inflation in fiscal years 1949 and 1950, the President recommended $4 billion of additional taxes from corporation incomes, upper individual incomes, and transfers of property under the estate and gift taxes.

Since the budget was submitted, it has become clear that inflationary pressures have been decreasing. Unemployment has risen; wholesale prices and industrial production have declined. A struggle for economic balance appears to be in process with excellent chances that it will be attained without a depression. Whether it is achieved depends in large measure upon the tax and fiscal policies pursued.

The pronounced distaste for deficits is wholesome and the determination to avoid them commendable in periods of high levels of national income. In the current situation, with the economy striving for balance and stability, the determination to avoid a deficit by imposing additional taxes would be sound only if the deficit were to have its origin in expenditures that exceeded the budget estimates for purposes not primarily intended to stimulate economic activity, such as defense and foreign aid. It would be unsound if the deficit had its origin in falling receipts or in rising expenditures associated with recession.

Corporate Income Tax Proposal Is Independent of Current Tax and Fiscal Outlook

I believe, however, that taxes on corporate income should be increased by the present Congress even if total Federal taxes are not increased. They should be increased even if mounting economic uncertainties should develop and dictate a reduction in aggregate Federal taxes. The proposals which I shall outline and analyze are entirely independent of any economic forecast. I do not intend to take a position with

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respect to the President's recommendation for $4 billion additional taxes.

Under the circumstances, when it would be appropriate to increase Federal taxes generally, corporate incomes would need to carry the brunt of the added burden. Doubling the estate and gift taxes would yield only an additional $0.75 billion. An increase of as much as five points in the rate of individual income tax on each surtax bracket except the first two would yield only another $0.75 billion. If the low and lower-middle income groups are to be largely spared from additional tax burden, as the President has suggested, his program would leave a minimum of $2.5 billion to be raised from corporations. The practical minimum might be closer to $3 billion.

It is not easy to devise acceptable plans to strengthen the transfer tax system by as much as $0.75 billion when the total estate tax base is less than $3 billion. If individual tax rates above the first two surtax brackets, i.e., above $4,000, were increased by five points, the new rates would exceed the highest wartime rates in the area of surtax income between $4,000 and $12,000, where a large part of the tax base above the first two surtax brackets is concentrated. Of the total surtax base, 82.5 per cent falls in the area under $4,000, and 62 per cent of the remainder falls in the area of surtax net income between $4,000 and $12,000.

Under unfavorable economic conditions, the total Federal revenue should be allowed to decline, but when so large a part of the system is comprised of excise taxes, as at present, it will decline less rapidly than is compatible with economic stability.

For the fiscal year 1950, excise taxes are estimated to yield $7.9 billion. It is not generally realized that in fiscal impact and economic effect this level of excise taxes is roughly equivalent to a general sales tax of 4.5 per cent of consumption expenditures on all goods and services, and is nearly 6 per cent of total consumption expenditures, excluding services. Moreover, these ratios, which are based on figures that relate to high levels of economic activity, would be materially increased under depressed business conditions. The economy has been able to carry the sales and excise tax burdens heaped on it during the inflationary defense, war, and postwar periods, without apparent stress, but it would not be a good risk to assume that it will be able to continue to do so with equal ease.

Some of the Federal excises have little to recommend them. They should be abandoned, before they have done injury to the economy. They are excessively regressive and destructive of profit potentials. Constituting highly variable and discriminatory business costs, such taxes are detrimental to competitive enterprise and an efficient allocation of resources. It is more urgent to replace them if the forecasts of business conditions are gloomy than if the forecasts are optimistic. In either event the case for action is strong.

Corporate incomes are the most promising source of replacement revenue. The corporate income tax is not collected currently and in this respect it is less than an ideal replacement source to improve the built-in flexibility of the Federal revenue system. But the tax is partly accrued and it would become more current under the proposed revisions which I shall outline. Even

the present corporate income tax is less repressive and less pro-cyclical than the worst excises.

It would require more cogent economic analysis than is undertaken in this paper to prove that a tax on corporate income is less depressing to economic activity than the better excises, but such analysis is not required when the comparison is made with the worst of them. The excise taxes retained must satisfy accepted standards of equity and serve some worthy social or economic objective. We can ill afford to indulge artistic urges for variety in taxation and vague yearnings for diversification.

The aggregate tax load has grown to huge proportions over the recent decades marked by two devastating wars and a great depression. The load must be packed and repacked to lighten its repressive economic effects. Growing governmental costs cannot be faced with equanimity unless tax and fiscal arrangements maximize real production. Real production must keep pace with and outstrip the rate of increase in public expenditures if the burden of taxation is to be lightened.

The performance of the free-enterprise system amply justifies our confidence in its great strength and virility. While it is safe to ignore the shouts of those who suffer intense pain with the slightest deviation in the government's fiscal policy from their own preconceptions, it is not safe to pursue tax policies that treat the American economy like a superior athlete in training, subjecting its production muscles to perpetual and increasingly severe tests of strength. The retention of the worst Federal excise taxes does just that.

Place of the Corporation Income Tax in the Revenue System

It is not easy to picture the place of the corporation income tax in the Federal revenue system, despite an abundance of available statistics relating to Federal receipts. One difficulty is that the receipts are gross, before refunds, which under the current collection system affects particularly the individual income tax and in some degree all other taxes, including corporate taxes. For all taxes, the refunds were more than $2.25 billion for fiscal 1948, and are estimated at somewhat more than $2 billion for fiscal 1950.

Total receipts, actual for fiscal 1948 and estimated for fiscal 1949 and 1950, by major categories of taxes, are shown in Table 1.

Gross collections from corporation taxes in fiscal 1948 were about one-half as great as from individual income taxes and about equal to all other tax revenue sources combined. Corporate taxes were about 25 per cent of tax and custom receipts, which amounted to $42.3 billion.

The receipts or collections from the corporate income tax do not indicate its net contribution to the Federal revenues. The net revenue from the corporation income tax is substantially lower than the collections, because if there were no corporate income tax the Federal Government would receive larger amounts of revenue from its individual income tax.

Some of the additional revenue would come from the larger dividends that corporations would be able to distribute to stockholders. The amount of profits available for dividends would increase

TABLE 1

FEDERAL RECEIPTS, FISCAL YEARS 1948, 1949, 1950

Item	1948 (Actual)	1949 (Estimate)	1950 (Estimate)
Amounts (in millions of dollars)			
Individual income tax	20,996.6	18,530.0	19,135.0
Estate and gift taxes	899.4	797.0	653.0
Direct taxes on corporations	10,174.4	11,709.0	12,252.0
Excise taxes	7,402.0	7,715.0	7,900.0
Employment taxes	2,395.7	2,610.0	3,324.0
Customs	421.7	407.0	407.0
Miscellaneous receipts	3,809.1	2,275.7	1,749.7
Total receipts	46,098.8	44,043.7	45,420.7
Percentage Distribution			
Taxes on individuals [1]	47.5	43.9	43.6
Direct taxes on corporations	22.1	26.6	27.0
Excise taxes	16.0	17.5	17.4
Employment taxes	5.2	5.9	7.3
Customs	.9	.9	.9
Miscellaneous receipts	8.3	5.2	3.8
Total receipts	100.0	100.0	100.0

Source: *Budget of the United States for the Fiscal Year Ending June 30, 1950,* pp. A11-A21.

[1] The first two items above are combined.

by the amount of the Federal tax repealed. Nobody can pretend to know precisely how dividend policies would be affected by repeal, but even if the added funds available were more largely retained than distributed, the Government would recapture part of the revenue surrendered. On the other hand, in the unlikely event that all the corporate tax saved were paid out in additional dividends, the Government would still lose some revenue. Apparently about 20 per cent of net dividends paid out by corporations do not find their way into the individual income tax base; they are received by low-income groups with incomes less than personal exemptions, by exempt organizations—religious, charitable, educational institutions, and perhaps too long a list of others specified in section 101 of the Code—and by individuals with weak memories and inadequate bookkeeping devices, both conducive to under-reporting. Moreover, the part of the corporate tax reduction reflected in additional dividends of taxable stockholders would not be completely recovered, since the top rate of the individual income tax is less than 100 per cent.

Another component of the additional revenue from the individual income tax that would partially offset the revenue loss from repeal of the corporate income tax stems from the retained earnings of corporations. To some extent, the larger retention of corporate profits that would be induced by repeal of the corporate tax would be reflected in higher market prices of the corporate securities. At the time of their transfer, perhaps after long periods of postponement, the Federal Government would receive larger revenue from the capital gains tax. But statistical studies show that only part of retained profits is likely to show up in higher market prices of securities. When such profits do appear, the statute makes certain

that only half of the capital gain is taken into account. Thus the tax on long-term capital gains is never more than one-half, and often less than one-half, the tax on ordinary income. The effective rate applicable to long-term capital gains cannot exceed 25 per cent. Moreover, the estate and gift taxes, particularly when combined with the lax basis rules of the income tax, provide ample potentialities for the complete avoidance, or at least perpetual postponement, of the watered-down capital gains tax.

Even if all the undistributed profits were brought to current account under the individual income tax by applying the partnership treatment to corporate income, the revenue loss from repeal would run to approximately $3 billion. Without bringing the undistributed profits to current account, repeal would cost roughly $7 billion. Thus, on a net revenue basis, the corporation income tax is about as productive as the entire Federal excise tax system.

There has been a significant shift toward the retention of a higher proportion of corporate profits. More than three postwar years have gone by without any signs that more normal relations between retained and distributed profits are likely to be restored with the completion of the transition period. The figures on corporate profits after tax liability and undistributed profits for selected prewar, war, and postwar years are shown in Table 2.

TABLE 2

CORPORATE PROFITS AFTER TAXES, SELECTED YEARS 1929-48

(In billions of dollars)

Year	Total	Dividend Payments	Undistributed Profits	Per Cent Undistributed
1929	8.4	5.8	2.6	31
1939	5.0	3.8	1.2	24
1943	10.4	4.5	5.9	59
1946	12.8	5.6	7.2	56
1947	18.1	6.9	11.2	62
1948	19.7	7.8	11.9	60

Source: *Economic Indicators,* April, 1949, p. 21.

The great majority of corporations are small and are owned by a few stockholders. Of the 363,000 corporations that filed balance sheets for 1944, 80 per cent had assets of less than $250,000. These corporations accounted for less than 4 per cent of total corporate assets and about 5 per cent of net income. For the same calendar year, roughly 87 per cent of the corporations had net incomes of $50,000 or less, but they received only 7 per cent of the total corporate net income.

It has been estimated that 70 per cent of nonfinancial corporations with assets under $50,000 and 50 per cent of nonfinancial corporations with assets between $50,000 and $250,000 are wholly owned by three or fewer officers who are full-time workers in their own enterprises.[1] Data compiled from 1936 individual income tax returns show that small corporations are more largely owned by low-income stockholders than by high-income stockholders, but

[1] *Survey of Current Business,* May, 1945, p. 7.

that low-income stockholders receive a larger percentage of their total dividends from large than from small corporations. The medium-sized corporation is owned predominantly by stockholders with substantial incomes.[2]

The total flow of dividends from corporations is concentrated very largely in the individual income area between $5,000 and $100,000. In 1943, 60 per cent of total dividends was received by individuals with incomes in this range. Of the remainder, 27 per cent was received by individuals with net incomes under $5,000 and 13 per cent by those with incomes over $100,000.

Corporate profits before taxes for the calendar year 1948 are estimated by the Department of Commerce at approximately $32 billion. Profits for tax purposes differ in various ways from the definition employed by the Department of Commerce; however, the $32 billion figure may be used to indicate current levels of corporate profits. We shall probably not err greatly if the 1944 breakdown by size of net income is assumed to hold for the current situation. On these assumptions, it would appear that $2.5 billion of additional revenue could be raised from corporations by increasing the rates about 8 points throughout, or if it were desired to spare the corporations with incomes under $50,000 by a 9 point increase applicable only to the flat-rate area. To raise $4 billion by corresponding rate revisions would require an additional 13 or 14 points respectively, which would carry the total rate to 51 or 52 per cent, depending upon whether the increase were made applicable to the smaller corporations. Such rates seem shockingly high. Yet they are based on optimistic levels of profits. Even if business activity is maintained at 1948 levels, corporate profits may not be.

[2] *Treasury Bulletin*, January, 1943.

Need for Corporate Tax Reform

It would serve little purpose here to analyze in detail the defects of various proposals that have been assessed, reassessed, and discarded periodically since the beginning of the income tax. Instead, I shall try to clarify the objectives of an integrated corporation and individual income tax system and to develop the outlines of a proposal which, in my judgment, makes the most practical approach toward our objectives, in the light of the revenue requirements of the Federal Government and institutional arrangements.

The excess profits tax need not detain us. It should be held in reserve to be used if an emergency of several years' duration becomes more clearly the prospect than now. At the end of World War I, President Wilson commended the excess profits tax to the Congress as a desirable source of peacetime revenue. But virtually every explorer of this treacherous tax domain has concluded that the excess profits tax is not a desirable source of peacetime revenue. The administrative and compliance problems associated with it are legion. The solution of technical problems and the developement of concepts and definition of objectives are not nearing the fruition stage. With the crude measurements of normal profits at our disposal, an excess profits tax, which in practical application ignores variations in business risks and effective employment of different

degrees of skill, would be unduly damaging to efficient allocation of economic resources.

Many theories of business taxation have been discussed. These theories do not lead in the same direction; each one carries a little distance—some farther than others—and drops off into a great void of bewilderment. Each theory has its stockpile of technical phraseology which serves to befuddle instead of enlighten the inquirer. The analysis must proceed afresh in terms of equity and broad economic and fiscal considerations.

The chief reasons for my opposition to untaxing corporate income are two—one primarily a question of equity; the other, of economic effects. Much of the tax has been capitalized. It is permanently imbedded and it would be impossible to extract it from property values. Some favor a quick transition to the no-corporate-tax world; others would skip the consequences of derating a capitalized tax by small hops instead of a leap. A more fundamental objection to untaxing corporate income stems from the undesirable economic effects of retaining the worst taxes in the present system while surrendering the less repressive tax revenue from corporate income. As already suggested, instead of reducing, I would increase the tax on corporate income to replace about $2-2.5 billion of Federal excise taxes.

The present model of the corporation income tax is not suitable to bear such an additional load. If the rates were merely increased, the present unintegrated income tax system would reveal its fundamental defects more clearly. They are well known.

The low-income stockholder is overtaxed in relation to the high-income stockholder. In the extreme case, a taxpayer intended to be free of income tax over the area of income represented by personal allowances is subjected to a 38 per cent tax at the corporate source.

The combined corporate and individual income taxes, even with loss offsets, but particularly without them (or if offsets are unduly limited), might drive the net return upon investment below the not too well defined venture-line to the prejudice of both total investment and its most effective distribution over variable business risks. This danger has been, at least, greatly mitigated by the Revenue Act of 1948, which inaugurated income splitting between husbands and wives. For married couples, but not for bachelors and spinsters, the marginal rates of tax have been substantially lowered in the area of steep progression between $5,000 and $100,000 surtax net income, into which some 60 per cent of dividends flow.

The tax on undistributed profits is at best postponed and at worst completely avoided. Even if allowance is made for inventory profits, higher replacement costs, and the persistence of shortages that block business development plans, it would appear that the problem of retained corporate profits is critical in its equity and more important economic aspects—more critical now than formerly because the tax rates and pressures to escape them are greater. Section 102, a provision for the prevention of unreasonable accumulation of surplus for the purpose of avoiding surtax, always has been and

is still ineffective. It is a hair shirt for business, the irritation varying with the type of legal and accounting advice purchased in order to interpret vague phrases used in the statute, court decisions, or administrative regulations and rulings. Section 102 may be overly effective in some few cases, but it is overwhelmingly ineffective in the aggregate, as the available data make abundantly clear. The Government profits little from these real or alleged discomforts of the taxpayer. A more direct and clearcut approach to the undistributed profits tax problem than Section 102 seems desirable.

One aspect of the tax postponement problem merits further elaboration, since some have understated its significance and proposed plans which are unacceptable on equity grounds in addition to or in lieu of the customary practical grounds—administrative, compliance, and political—that have hitherto marked them for discard. I refer to proposals that would eliminate the corporate income tax and seek equitable and economically beneficial results in (1) a revitalized capital gains tax, with rates raised to ordinary rate levels, (2) blocked avenues of escape from transfer taxes, and (3) an averaging system. I do not propose here to question the security market's efficacy in reflecting undistributed profits with reasonable completeness and attaching them to the appropriate taxpayers under conditions of constantly changing ownership. These problems are well known and are being discussed extensively.

It is more important to meet the issue of tax postponement head-on. I do not believe that the inequities of postponement can be untangled by mathematical formulae, even with an interest charge for the privilege of postponement. The reason is that over considerable periods of time, say a decade or more, opportunities to reap economic rewards may vary greatly as the fundamental economic conditions swing through different business cycles or change in response to national emergency situations. I cannot accept as equitable a tax philosophy which would permit the refund of taxes collected from fortunes extracted in a brief few years by the lucky, or even the skilled, from sporadic economic situations like Florida land booms, stock exchange and commodity speculative orgies, wars, and, as an economist might say, quasi-wars to be enjoyed over the remainder of their potentially inactive and useless lives. Least sacrifice, minimum sacrifice, or any other variety of that venerable group of theories is inadequate once the ability-to-pay period is stretched over too long a span of time. Averaging of the type that spans relatively short periods, a business cycle or so, would improve equity in taxation. But lifetime averaging, or averaging that covers long periods, would on this account destroy the equity of a tax system. If two taxpayers during their working lives span vastly different economic circumstances and have identical lifetime incomes that are distributed differently through periods of prosperity and depression — or more generally through periods of extraordinary and ordinary economic activity — should have the same aggregate tax bill, it would be proof enough that they had lived under an unjust tax system, not a just one. Merely to take into account for tax assessment purposes the number of dollars accumulated to the

end of the lifetime route, thus abstracting from current interpersonal alignment of taxes, strikes me as a peculiarly callous procedure in equity and as highly undesirable as regards the impact on the allocation of economic resources.

The upshot of all this discussion of averaging and postponement, for immediate purposes, is that in a desirable type of integrated corporate—individual income tax system the undistributed profits of corporations should be brought to current account to the fullest practicable extent. That, it seems to me, is one of the most important criteria of integration.

It would take me too far afield were I to attempt to discuss here the conflict between fiscal policy requirements for flexibility in taxation and the equities of averaging. My conclusion on this issue, on balance, is in favor of short-term averaging.

Another defect in the present tax system stems from the important tax consequences of doing business under different forms of organization. The proprietorship, partnership, and corporation feel the tax pressures in varying degree under any one statute, and as tax laws change, the pattern of relative tax burden changes, so that now the tax consequences favor one and now another form of business organization. Cooperatives, even if not tax exempt, may feel no tax pressures at all.

The Revenue Acts of 1945 and 1948 drastically changed the tax weights between incorporated and unincorporated business. The wartime excess profits taxes superimposed on high corporate rates had tipped the scales in the direction of disincorporation. The 1945 act, by lifting the excess profits tax, the capital stock and declared value excess profits taxes, and a few points of regular income tax rates, tipped the scales in favor of corporations. The Revenue Act of 1948 allowed income splitting and thus again tipped the scales in the direction of disincorporation. Except where bachelors or spinsters are involved, it had the effect of making partnerships out of proprietorships without fighting the Treasury and courts to determine whether the family partnership was legitimate; it doubled the partners of all partnerships.

The worst features in such shifting tax pressures are that they disturb competitive arrangements, for while frequently the transformations of type of business organization can be made at a low tax price, compliance annoyances may be considerable and stabilized business connections may be severely wrenched. Moreover, the great majority of taxpayers cannot be perpetually computing their maximum tax advantage in the light of unknown factors involving difficult forecasts of the size of their outside income, the size of the income from the business, the prospects of marriage or divorce, the required amounts of income withdrawals from the business, and similar variables. Yet this is the type of data which determines the breaking point of tax advantage of doing business under the incorporated as against the unincorporated form of organization. Moreover, the nontax advantages of doing business as a corporation may be great enough for the taxpayer to bear higher tax burdens even if he belongs to the minority which keeps up with the computations of maximum tax advantage.

I hope that the criteria for an acceptable integration plan have been

clarified in the foregoing critique of the present arrangements. I place a substantial premium on making the combined corporate and individual income tax more current rather than less current. In this respect, I find Professor Robert Murray Haig's work on this problem in greatest accord with my approach, although he was actuated more largely by considerations of equity than of fiscal and economic effects.

Early in the history of the income tax, Professor Haig developed a comprehensive concept of income which has influenced many students of public finance. As the concept was developed in connection with his special work on capital gains taxation, he proposed to take into current account the changes in net worth of a taxpayer as reflected in his balance-sheet position at the end of the year by comparison with his position at the opening of the year. Unrealized capital gains and losses on property holdings, including corporate securities, would be estimated for tax purposes. Clearly, there are serious practical barriers to the plan involving tax payment, valuation, and other problems, including perhaps constitutional prohibition. On the assumption that the market is efficient to measure and allocate the tax on undistributed profits to appropriate taxpayers, the plan to tax appreciation in value of capital assets currently is similar to the partnership approach endorsed in 1939, to the greatest extent administratively and legally feasible, by the Committee of the National Tax Association on Federal Taxation of Corporations.[3] Professor Haig was chairman of that committee.

[3] *Proceedings of the National Tax Association*, 1939, p. 555.

In this paper, it is not essential for me to argue, on grounds of administrative and legal considerations, the pros and cons of either the current capital-gains or the partnership approach. Definitive research on the feasibility of the partnership approach still has to be done; it is worth doing; and the contribution which such research could make to the problem under discussion might be significant even if the results were negative.

In my view, the partnership approach should be abandoned because it would not yield desirable economic results. It is also defective on equity grounds for it identifies stockholders' and management interests against abundant evidence that they are not identical, especially in the case of big business. Efforts to restrict the partnership method to small business would suffer from serious difficulties in drawing a dividing line. The difficulties are conceptual as well as practical. To give but one illustration, there is little guidance in the suggestion that the partnership option be confined to corporations with " simple capital structures " when large bank indebtedness is characteristic of small business and causes much of the difficulties which this limitation seeks to remove. Space does not permit a catalogue of criteria of how to draw the line to define the appropriate area for partnership treatment of small business, but my impression of nearly all of them is that they are beclouded by reasonable sounding but not very helpful verbiage.

But the economic objection to both the current capital-gains and partnership treatments of undistributed corporate profits is the critical one. These plans do not interfere with corporate

savings. I believe, on the contrary, that for economic stability Federal corporate income tax reform should be designed to reduce corporate saving to the minimum compatible with effective functioning of corporations as economic institutions. Specifically, I believe that all the search in 1936-37 for administrative and legal ways of currently taxing undistributed corporate profits to the stockholders without making the corporations pay out cash was a mistake. I hope that this error will not be repeated if an undistributed profits tax is undertaken again. We made many large-sized obvious errors in connection with the 1936-37 experiment, including inadequate provision for loss offsets, for inventory profits, and for small business. But I am confident we can build a satisfactory integrated income tax for the future on the undistributed profits tax principle if such mistakes are eliminated.

A Proposal

Specifically, I suggest that the present corporate income tax be replaced by the following system: (1) a normal corporate tax of 20 per cent; (2) a surtax of 25 or 30 per cent on profits after (a) normal tax, (b) dividends, (c) specific exemption of $50,000; (3) in lieu of section 102 a supertax of 65 or 75 per cent on profits after (a) normal tax and surtax, (b) dividends, (c) specific exemption of $50,000, or one-quarter of the profits after normal tax, if greater than $50,000.

The specific rates indicated may not yield the desired replacement revenue, in which case I should differentiate the basic or normal rate by adding for corporate net incomes in excess of $50,000 as many percentage points as are needed. The more revenue that is derived from the individual income tax rates applicable to larger distributions of corporate profits, the more current does the combination of corporate and individual income taxes become.

The equity capital markets would improve with the larger corporate distributions, and small business would have a better chance to get equity capital. But the available data on cost of flotation, compiled by the Security and Exchange Commission for listed corporations which in general are big corporations in comparison with the entire corporate population, should be convincing evidence that the capital requirements of small business cannot be taken care of adequately by direct security flotations. To view the capital shortage plight of small business as a tax issue serves only to confuse public understanding of a critical problem and to postpone direct measures designed to make capital available to them on more certain and cheaper terms than at present. Here is a great opportunity for financial private enterprise to work out means of pooling small and medium-sized business risks. The first $50,000 of corporate income profits would be placed under the protection of the lower rate of undistributed profits tax, partly in recognition of the greater capital needs of small business, partly because this is compatible with equity requirements, but chiefly because some differentiation in rate is justified to equalize the tax pressures between small and big businesses with diversified activities.

For large business, the improvement in the equity capital markets would be significant. It would spoil the game,

which some find both profitable and pleasurable, of retaining the corporate dollars and then looking for them in vain in the equity capital markets, with registered disappointment that they cannot be found in both places at once. Large business would get the protection of the low-rate undistributed profits tax up to one-quarter of the profits after basic tax. The most serious pressures would be on the medium-size corporations. To the extent that they are owned by large-income stockholders with adequate financial connections, this might not be too critical a matter, but it might well necessitate interim Government financing on favorable terms, pending the development of private-enterprise financial institutions for pooling small business risks.

The suggested integration plan would achieve greater equality among different forms of business organization. When the general reform of the corporate tax is undertaken it would seem desirable to repeal the tax exemption of cooperatives. Cooperatives not specifically exempt are already being taxed on a basis harmonious with the undistributed profits tax principle. The repeal of the exemptions would subject to tax their reserves, dividends on stock, and minor amounts of miscellaneous income. I am not suggesting that anything need be done about patronage dividends. Other special corporate tax features like those applicable to investment trusts, building and loan associations, and insurance companies, to mention but a few, should be re-examined for harmony with the reformed income tax. Doubtless some financial institutions will still have a clear case for special treatment under the new integrated plan, but other financial institutions may well be brought under the cover of the proposed plan which should be as nearly universal as practicable.

A GENERAL SALES TAX AND THE LEVEL OF EMPLOYMENT: A RECONSIDERATION

JOHN F. DUE *

DURING the years immediately preceding the war, the subject of incidence of sales taxes received considerable attention.[1] The interest was in part a product of the development of retail sales taxes in the states during the decade of the 'thirties and in part a result of the realization that incidence analysis had lagged far behind the developments in economic theory during the preceding years. The incidence discussion of this period, which centered around the question of price changes resulting directly from the tax, brought the analysis in line with contemporary value theory. Since the latter has developed but little (apart from further refinement of oligopoly pricing) since that time, there is little to be added to this aspect of incidence at the present time. But the portion of the discussion which was concerned with the secondary modifications of the initial incidence,[2] produced by the effects of the price increases (or reduced factor productivity) upon sales, production, employment, and factor prices, was seriously inadequate, primarily because it lacked as a foundation a completely developed theory of national income. In recent years national income analysis has been materially improved, and as a result, reconsideration of the earlier discussions of the effect of a sales tax upon employment is desirable.[3]

PREVIOUS ANALYSES OF THE EFFECTS OF SALES TAXES UPON EMPLOYMENT AND FACTOR PRICES

The analysis of secondary reactions modifying the initial incidence pattern has usually been based upon the principle that unemployment of resources would arise as the result of initial reactions to the tax. H. G. Brown explained the origin of this unemployment in terms of reduced marginal productivity of the factors; since the marginal productivity of labor and other factor units would be lowered as a result of the tax, fewer workers and other factor units would be employed.[4] He maintained that no price level increase would occur in response to a gen-

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1 Note for example H. G. Brown, "The Incidence of a General Output or a General Sales Tax," *Journal of Political Economy*, XLVII (April, 1939), 254-62; E. D. Fagan and R. W. Jastram, "Tax Shifting in the Short Run," *Quarterly Journal of Economics*, LIII (August, 1939), 562-89; D. W. Gilbert, "The Shifting of Sales Taxes," *Quarterly Journal of Economics*, LIII (February, 1939), 275-85; Otto von Mering, *The Shifting and Incidence of Taxation* (Philadelphia: Blakiston, 1942); J. F. Due, *The Theory of Incidence of Sales Taxation* (New York: Kings Crown Press, 1942).

2 If the concept of incidence is defined narrowly, these secondary reactions must be termed "effects." Regardless of the terminology, they influence the final location of the burden of the tax.

3 Some of the recent public finance texts have avoided the errors in reasoning of the earlier analyses, but have given little specific attention to the problem. See E. D. Allen and O. H. Brownlee, *Economics of Public Finance* (New York: Prentice-Hall, 1947; Philip E. Taylor, *The Economics of Public Finance* (New York: MacMillan, 1948); W. Withers, *Public Finance* (New York: American Book Company, 1948).

4 *Op. cit.*, pp. 255-56.

eral sales levy.[5] In my own analysis I argued that a general price level increase would occur, but maintained that unemployment would arise because the higher prices would reduce sales and thus production.[6]

On the assumption of a decline in employment, the analyses proceeded to consider factor price adjustments resulting from the unemployment, and the effects of these adjustments upon incidence. According to Brown, factor prices would decline until the unemployment had been absorbed; as a result, the burden of the tax would rest upon the factor owners, and thus primarily upon workers, the receivers of the greatest total share of income. Consumers as such would bear none of the burden.[7] He recognized that the "stickiness" of factor prices, owing to institutional factors such as labor unions, would interfere somewhat with the factor price adjustments and prolong the period of unemployment.[8] In my own discussion, I stressed these institutional factors and the fact that wage declines would not necessarily increase employment, and concluded that a portion of the burden would rest upon the consumers[9] and a portion on suppliers of money capital and labor.[10]

The chief difficulty with this line of analysis lies in the basic premise that a decline in production and employment results from the initial reactions to the tax. This difficulty, in turn, arose out of the failure to trace satisfactorily the effect of the expenditures of the tax revenues by the government. Brown does not consider any effect that the expenditures might have in maintaining productivity of the factors; he does specifically note that after adjustment is complete the sum of private and public expenditures will equal the sum of private expenditures prior to the imposition of the tax.[11] But he fails to realize the significance of this situation for the nature of the final adjustment itself. In my analysis, I argued that the spending of the tax receipts by the government does not restore the original volume of employment, but "merely replaces the spending that would otherwise have been done by those not suffering reduced purchasing power because of the existence of the tax (that is, those becoming unemployed). The check on employment caused by the cost increase remains."[12] This line of reasoning is clearly fallacious.[13]

[5] John Stuart Mill had likewise argued many years earlier that a general sales tax could not cause an increase in the general price level. (*Principles of Political Economy* [Ashley ed.; London, 1923], p. 837).

[6] *Op. cit.*, pp. 26, 104-11.

[7] *Op. cit.*, p. 257.

[8] *Ibid.*, pp. 261-2.

[9] In industries of restricted entry and monopoly profits, some of the burden would not be shifted forward, and would rest upon the owners of the business.

[10] *Op. cit.*, pp. 114-15.

[11] *Op. cit.*, p. 259.

[12] *Op. cit.*, p. 215, note 30.

[13] The effect of sales taxes upon national income (and thus on employment) was traced very briefly but accurately by Michal Kalecki, in "A Theory of Commodity, Income, and Capital Taxation," *Economic Journal*, XLVII (September, 1937), 445-47. He was not concerned with the problem of incidence.

Otto von Mering, in his *Shifting and Incidence of Taxation, op. cit.*, takes the position that "the discussion of the effects of public expenditures is no part of the theory of tax shifting" (p. 133). Subsequently he discusses briefly the question of the effect of expenditure of the sales tax revenue (pp. 135-36), but he does not make use of this discussion

RECONSIDERATION OF THE EFFECT OF A SALES TAX UPON EMPLOYMENT

A Full Employment Situation

Attention will be given first to the effect upon employment of a sales tax levied to provide funds for new governmental activities (national defense, for example), the situation being one of full employment of resources at the time the tax is introduced.

In this situation, there are two conflicting forces affecting employment. So far as private consumption is concerned, the higher prices which the consumers must pay will result in a reduction in the total volume of goods which they are buying; if they continue to spend the same amount of money on consumption as they did before the tax, the total amount of privately produced goods which they are buying will be reduced by the amount of the total tax revenue (assuming that the entire tax burden is initially shifted by the sellers to the consumers).[14] On the other hand, the government is spending the tax revenue, in part to obtain resources for direct use in rendering the services, and in part to buy privately produced goods, the production of which requires the use of factor units. What is the net effect of these two forces, so far as employment is concerned?

If, as assumed above, total individual consumption expenditures remain unchanged as a result of the tax (and thus consumer purchases of privately produced goods are reduced by the amount of the tax revenue collected), the total volume of production and employment will remain unchanged. Reduced purchases of privately produced goods will cause a decline in production of the latter; resources freed by this decline will be absorbed in the production of the government services. Some will be employed directly by the government, others by private firms producing goods for sale to the government. Since in general the expenditures of the dollars of tax revenue by the government should result in the employment of as many factor units as would the expenditure of those dollars by the persons who would have bought privately produced goods with them in the absence of the tax, there will be no net decline in employment. Some readjustments of individual factor prices will almost certainly occur, since the government will probably not desire exactly the same types of factor units as would have been employed privately in the absence of the tax.[15]

In other words, a certain amount of purchasing power is being taken away from individuals through the additions to the prices of privately produced goods which they are buying, these additions consisting of tax payments. These " additions " go to the government in the form of tax revenue; they are used to cover the costs of the new services being rendered. Thus consumers as a whole will be getting less

in his basic treatment of incidence, in which he considers factor price declines to be of substantial importance in the final incidence pattern (pp. 173-74).

14 The initial pattern of incidence is discussed in detail in Due, *op. cit.*

15 Some of the first writers to point out the need for considering expenditure effects in determining incidence stressed this type of adjustment. See M. S. Kendrick, *Taxation Issues* (New York: Harper, 1933), pp. 122-29, and A. deViti de Marco, *First Principles of Public Finance* ([transl.] New York: Harcourt Brace, 1936).

privately produced goods than previously, but more government services. The resources freed from private production will be absorbed in the production of these additional government services. National income will remain the same in total, but will be made up of a smaller quantity of privately produced goods and a greater quantity of government services; gross national product at current prices will be higher by the amount of the taxes, since the general price level will be higher.[16]

Suppose, for example, that the government increases military expenditures and finances the program by means of a sales tax. The tax will produce increases in the prices of privately produced goods. Thus the total volume of these goods purchased will fall; men and other resources will be freed from private production. At the same time, the government will be "hiring" additional men for the armed forces, buying clothes and other supplies for them, and buying ammunition, gasoline, etc. for their training. As a general principle, the total volume of resources freed by the decline in private production should equal the amount being used by the government.

The analysis up to this point has been based upon the assumption that total expenditures by consumers are the same after the tax as before; thus consumption (and production) of goods privately produced and consumed is being reduced by the amount of the tax revenue. If this assumption is not realized in practice, the volume of employment may be affected. There are two possible modifications of the assumption.

In the first place, many consumers will not absorb the entire tax out of consumption expenditures; they will increase these expenditures at the expense of saving. This reaction will be most common in the higher-income levels; only in the lowest levels is the tax likely to be borne entirely out of consumption. To the extent that investment is unaffected by this reduction in the propensity to save, the net effect will almost certainly be inflationary; that is, the government will be attempting to obtain more resources than the amount freed by the decline in private production; as a result, competition for resources will bid prices up. The net result will be an increase in the general price level. This in itself is not directly significant for the volume of employment,[17] but it may serve to offset the possible deflationary effect of the tax discussed below, which would otherwise modify incidence. It should be noted that from the standpoint of the effect on the consumption-savings ratio, the sales tax method of financing the increases in expenditures

[16] The question of necessary monetary readjustments is discussed below.

Question may be raised whether a price increase of this sort should itself be considered to constitute inflation. The question is one of terminology; it would seem most satisfactory to define the term *inflation* in such a way as to exclude price increases of this variety. Essentially consumers are paying no more for goods than before. They are merely making supplementary payments for governmental services along with the prices they are paying for privately produced goods being purchased, rather than having these payments withheld from their paychecks, or being required to make them in annual lump sums, or in some other fashion. As discussed below, these tax-induced price increases may produce subsequent reactions which are truly inflationary in the usual sense of the term.

[17] Nor for incidence. The inflation will benefit some groups in the economy at the expense of others, but under usual concepts of incidence it could not be said that any portion of the burden of the tax rested upon those injured by the inflation.

is likely to result in less net inflationary effect than the income tax method, since the income tax will be borne to a greater extent out of current saving than will the sales tax.[18] The sales tax method allows far less inflationary effect than financing by borrowing. In the case of the latter, resources needed by the government must be pulled away from private enterprise by bidding for them in the market; a general price increase is almost inevitable. The only exception would be the case in which government borrowing reduced private consumption drastically (through some type of savings-bond drive) or checked private investment greatly by driving up the interest rate or curtailing bank lending.

On the other hand, some consumers may react to the sales tax in a manner directly opposite to that just discussed. The sales tax provides a definite incentive to curtail consumption, since, if a person does so, he can reduce his total tax payment. Accordingly, it is possible that some persons will be induced to curtail expenditures to such an extent that their total consumption expenditures, including amounts paid in sales taxes, are less than they were prior to the introduction of the tax. In other words, not only are they absorbing the entire tax burden out of consumption expenditures, but in addition they are increasing savings at the expense of consumption in order to avoid a portion of the tax. If a sufficient number of persons react in this manner, the total reduction in expenditures of this group might more than offset the total increase in expenditures of those persons who absorb some of the tax out of current savings. In this event the government expenditures will not offset the decline in private expenditures, and unemployment of factors will arise, with subsequent modifications of incidence. But such a possibility appears to be a very remote one. The lower-income groups cannot make substantial reductions in consumption. In the higher levels, there is good reason to believe that typically the tax would be absorbed in savings; the same is likely to be true for many persons in the middle-income levels. In general, it seems most likely that a net inflationary effect will be the result of the program.

A Situation of Partial Employment

The analysis to this point has been based upon the assumption of full employment at the time of introduction of the levy. Suppose, however, that not all resources were fully employed at the time the tax was imposed; will the effect of the tax upon employment be different? In general, there is no reason to expect any difference. The analysis that applies to a situation of full employment applies equally to a situation of partial employment so far as any loss in employment is concerned. When the net effect of the tax-expenditure program is inflationary, however, a difference arises in respect to price increases. When unemployment exists, the primary effect of the net increase in expenditures which results from the program will be an increase in production, rather than a substantial increase in prices. National income will rise, in real as well as in monetary

[18] This statement is not meant to infer that in a period of inflation income taxes should be replaced by sales taxes. The effect of the latter on wages, discussed below, must be considered, as well as the relative equity of the two taxes.

content, and a portion or all of the previous unemployment will be eliminated. But for the same reason that the sales tax method of financing will result in a smaller general price level increase than an income tax or borrowing method in a full employment situation, the sales tax method will be less effective than the other methods in eliminating unemployment.

Support Functions

Suppose that in a situation either of full or partial employment the sales tax revenues had been used to finance new support functions of government, that is, to provide greater relief or old age pension grants, for example, rather than to finance new governmental services such as national defense or road construction; would the effect on employment be different? In this case the government itself is not hiring additional factor units, nor is it buying additional goods; it is merely making transfer payments to individuals dependent on the government for financial support. However, the net effect on employment will not be substantially different than in the case discussed above. The recipients of the transfer funds will spend them; if the increase in their consumption equals the net decline in consumption of privately produced goods by the taxpayers, the volume of employment and national income will remain unchanged. If they increase expenditures by an amount in excess of the reduction, as is possible because of their high propensity to consume, there will be a net inflationary effect, or, with partial employment, an increase in production.

Use of Sales Tax Funds for Debt Retirement

A third possible use of sales tax revenues is to provide funds for increased debt retirement. In this situation, the net effect is almost certain to be a decline in employment. The recipients of the funds are not likely to spend any substantial portion of them on consumption; had they desired to consume this portion of their wealth they would have sold or redeemed the bonds without waiting for redemption. In some instances the recipients may use the funds to make expansions in their own businesses which they would not otherwise have made. These cases are also likely to be exceptional, for if good opportunities for expansion had existed the bonds would have been sold to provide necessary funds. To the extent that the recipients are financial institutions, the latter are placed in a more liquid position and can increase loans to private enterprise. This fact is of no significance if they had idle reserves anyway; if they did not, they would likely have sold the bonds prior to redemption to make loans, had good private investment opportunities arisen. It is true that the repayment of the loans leaves more funds in the hands of some persons to invest (except to the extent that the redemption merely results in a reduction in demand deposits); the net result, however, is most likely to be merely an increase in the demand for existing securities, and a consequent increase in their prices. The consequent decline in the interest rate might provide some stimulus to private investment; this reaction is not likely to be very significant.

A loss of full employment would occur, however, only if the effects of the tax-bond-redemption program were not offset by other inflationary influences at work during the period. Thus if the general price level were stable at the time of the introduction of the program, a decline in national income and employment is most likely. But if there was a tendency toward inflation at the time the program was introduced, the deflationary effects of the tax might be offset, and no loss in employment would occur.

Replacement by the Sales Tax of Other Revenue Sources

A final situation to note is that in which a sales tax is introduced in order to allow a reduction in other sources of revenue, the level of government expenditures remaining unchanged. If the sales tax replaces borrowing or a highly progressive income tax, the net result of the change is almost certain to be a decline in employment, regardless of the initial employment situation, unless the deflationary effect is offset by other inflationary forces operating at the time. The sales tax curtails consumption to a far greater extent than a borrowing program, under which funds come almost entirely from the portions of income being saved.[19] A sales tax borne to a large extent by the lower-income groups almost certainly has more effect on consumption than does an income tax, which, because of its progressive nature, is borne to a considerable extent out of the savings of middle- and upper-income groups.[20] If the sales tax replaces the portion of an income tax on the lowest income levels subject to tax, the net effect is not so obvious; the net deflationary effect may be slight. There is likewise doubt whether a sales tax would be more deflationary than an excise tax system or the general property tax, neither of which is significantly progressive in effect.

Summary

The argument of the preceding paragraphs can be summarized briefly. When sales taxes are used to finance new governmental services or new support payments to lower-income groups, it is most unlikely that any net reduction in employment will occur. Actually, if full employment existed when the program was started, the net effect is likely to be inflationary, because of the over-all increase in propensity to consume. Accordingly, there is no reason to expect any reduction in factor prices (although some readjustments in prices of particular factors will occur), and thus the burden of the tax will remain upon the consumers, to whom it is shifted by the business firms which pay the tax to the government.[21] Accordingly, the general price level will be higher, since, in general, prices will have been raised by the amount of the tax; gross national product at current prices will be higher although unchanged in real terms, and national income (in both real and monetary terms) will remain unchanged.

[19] Unless the program is accompanied by an intensive patriotic appeal, as the wartime savings bond campaign.

[20] If the reduction in income taxes stimulated investment, the increase in the latter would offset, in part at least, the effect of the decline in consumption caused by the sales tax.

[21] A small portion of the tax may rest upon the owners of firms enjoying monopoly profits.

Only in cases in which the sales tax revenues are used to retire debt, or to replace borrowing or income taxes on the higher income levels as sources of revenue, would there be any likelihood of a decline in employment. Even in these cases the deflationary influences may be offset by other inflationary influences at work in the economy. Should unemployment arise, some factor price readjustments, with consequent modification of incidence of the tax, would occur.[22]

Accordingly, the conclusion is reached that the final distribution of the tax burden is affected to some extent by the manner in which the tax revenues are used by the government and by the existence or absence of inflationary influences at the time of the imposition of the tax. This conclusion suggests reconsideration of the question of the most satisfactory scope of the concept of incidence. If the latter is defined broadly as the final pattern of distribution of burden after all readjustments consequent to the imposition of the tax have occurred, factor price readjustments of the type discussed above must be taken into consideration. However, this procedure results in the inevitable conclusion that the final incidence of the levy depends upon the manner in which the tax proceeds are used, as well as upon the strength of inflationary elements at the time of imposition of the tax. But the alternative—to define incidence more narrowly in order to exclude these complicating adjustments—raises serious problems in regard to the exact line between incidence and effects. Furthermore, the incidence pattern with the concept defined narrowly fails to give a complete picture of the final distribution of tax burdens. It is still preferable, in my estimation, to use the broad concept of incidence, even though to do so means that incidence is influenced by the manner of use of the revenue funds.

[22] Institutional factors will seriously interfere with factor price readjustments. See Due, *op. cit.*, pp. 105-11, for a more complete discussion.

Monetary Readjustments

As indicated above, ordinarily the levying of a sales tax will lead to an increase in the general price level. This increase will necessitate an additional supply of money to handle the greater volume (in monetary terms) of transactions. If such an additional supply is not forthcoming, interest rates will of necessity rise. In part, the commercial banks may be able to create the additional money through the making of new loans, provided they have excess reserves. If this adjustment is inadequate, Federal Reserve action will be necessary; such action would ordinarily be forthcoming, since the Reserve system would not wish to see an increase in interest rates in the situation under discussion. If, for any reason, the monetary readjustments did not occur, the increases in interest rates might curtail investment and produce unemployment.

The Sales Tax and Wage Increases

There is one final influence which a sales tax may have upon certain factor prices that was overlooked in many earlier incidence discussions, namely, the effect of the tax in producing wages increases. Since a sales tax affects cost of living indices, in those industries in which wages are tied

closely, by contract or otherwise, to the indices, wage increases are likely to occur when the tax is imposed. As a result, the portion of the tax resting initially on these workers (as consumers) may be shifted to other consumers and to a limited extent to the owners of the industries involved. This change would produce still further increases in the general price level and gross national product, and an increase (in monetary terms, not real content) in national income.

The Present State Retail Sales Taxes

In conclusion, attention will be given briefly to the question of the effects on employment of the present state retail sales taxes. If these taxes did not exist, it is likely that in part state expenditures would be lower than they are, and in part other state taxes—primarily property, income, and excise taxes—would be higher. To the extent that the sales taxes are allowing higher levels of state expenditure for service and support functions, it is most unlikely that the volume of employment is adversely affected. To the extent that other levies would be used in the absence of the sales tax, the latter may be regarded as having some deflationary effect. In the 1930's the net result of the state sales taxes may have been a somewhat greater volume of unemployment. Since 1942 the effect has been merely to hold in check to some extent the inflationary forces at work in the economy. But it is doubtful whether in either period the sales tax would have had much more deflationary influence than property taxes (borne to a considerable extent by those in the lower-income groups) or the types of income taxes (with slight progression) used by the states. In a depression period, of course, the use of borrowing instead of sales taxes would facilitate recovery.

BOND INTEREST DEDUCTION AND THE FEDERAL CORPORATION INCOME TAX

GEORGE E. LENT *

THE DEDUCTIBILITY of bond interest has been one of the major conceptual and practical problems arising in the determination of net taxable income since the adoption of the Federal corporation tax. The possibility of tax avoidance by the substitution of bonds for stock was recognized by the Committee on Ways and Means even at the low rate of 1 per cent assessed by the corporation excise tax of 1909.[1] Most committee members were initially opposed to any interest deduction but they finally limited it to an amount on indebtedness not exceeding the paid-up capital stock at the end of the year.

The Income Tax Act of 1913 modified the restriction to interest on indebtedness not exceeding one-half the sum of interest-bearing debt and paid-up capital stock.[2] The Revenue Act of 1916 further relaxed the limitation, and the Revenue Act of 1918 finally permitted full deduction of all interest paid or accrued on indebtedness with the exception of that incurred to purchase tax-exempt securities.[3] The limitation was removed because the excess profits tax offset the advantage of debt financing but the issue was not revived with the repeal of this war-time measure. With the exception of minor changes in 1932, repealed in 1934, bond interest has been consistently allowed in determining corporation net taxable income since 1918.[4]

Criticisms of Present Policy

The Concept of Taxable Income.—Bond interest is legally a fixed contractual cost of borrowed capital whose current payment is not contingent upon earnings. Dividends, on the other hand, are properly payable only out of the earnings of a corporation. In principle, however, both interest and dividends represent divisions of the net return on invested capital. That is, the capitalization of a corporation consists of equity and creditorship contracts which in reality represent different orders of claims on the prospective earnings of capital. While interest is legally payable whether earned or not, it can continue to be paid in the long run only if earned.

The use of bonds is illustrated by the principle of " trading on the equity " by which fixed-income claims are used to enhance the return on equity capital. They are thus an alternative contractual method of securing capital, which provides for a fixed rather than contingent commitment by the corporation

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[1] R. G. Blakey and G. C. Blakey, *The Federal Income Tax* (New York: Longmans, Green & Co., 1940), pp. 46-47.

[2] Section II G (b), 38 Stats. 173.

[3] Section 234 (2), 40 Stats. 1077.

[4] Since 1942 public utility companies other than railroads have been allowed a credit for dividends paid on preferred stock issued prior to October 1, 1942, in computing surtax net income.

in the distribution of earnings. The distinction between bonds and capital stock is frequently blurred in fact by the provision for interest payments only if earned, as in the case of income or readjustment bonds.[5] The deduction of bond interest as a cost of business clearly ignores the realities of corporation finance which conventionally regards earnings before bond interest as a measure of financial success. If the present theory of the corporation tax is to be retained, corporation bond interest charges should logically be included as a part of net taxable income, unless there are other compelling reasons for their exclusion.

Incentive to Debt Financing.—The deduction of bond interest is generally conceded to encourage the use of bonds rather than equity securities in the capital structure. The tax advantage of debt financing may be illustrated by the hypothetical case of a $10,000,000 corporation with a prospective rate of return of 10 per cent on its investment, before income taxes. Financing entirely by the use of equity securities (common and preferred stock) would result in the payment of $400,000 a year in income taxes, at a rate of 40 per cent. Substitution of a $5,000,000 bond issue with interest at 5 per cent would reduce net taxable income by $250,000 a year and save $100,000 annually in corporation taxes, or 25 per cent of the tax bill. As a result, net return on investment after taxes would be increased from 6 to 7 per cent, an increase of 16⅔ per cent.

In contrast with the deduction of bond interest, no allowance is made for preferred stock dividends. Since preferred stockholders have a fixed claim on earnings, income taxes applicable to preferred dividends are in general borne by the common stockholders (if the tax is not shifted). In the above example, if 5 per cent preferred stock were used instead of bonds, the effective rate of corporation tax on common stock profits would be increased from 40 to 53 per cent. The greater the share of preferred dividends in taxable income, the higher the effective rate of tax on common stock equity. If preferred dividends were equal to 50 per cent of taxable income, a corporation rate of 40 per cent would be equivalent to 80 per cent on the common stockholders' share. The tax discrimination thus created against preferred stock in favor of borrowing is clearly unwarranted by the nature of the difference in the property rights defined by these two types of securities contracts.

The premium placed on corporation borrowing by Federal tax policy is charged with encouraging unsound financial practices.[6] The necessity of meeting excessive fixed-interest commitments and bond maturities entails undesirable social and economic consequences which should be avoided. The unfortunate experience of the railroad industry in this respect is well known. In times of adversity, property tends to be undermaintained, wages and employment curtailed, and business development in general retarded in order to protect business liquidity.

[5] One notable example is the Pennsylvania Central Airlines Corp. $10,000,000 convertible income debenture 3½'s due 1960. The only real distinction between this issue and preferred stock is the maturity date. Bond interest is payable only if earned but is cumulative without interest on arrears.

[6] See, for example, H. M. Groves, *Postwar Taxation and Economic Progress* (New York: McGraw-Hill Book Co., Inc., 1946), pp. 31-35.

Bankruptcy and reorganization are frequently precipitated and a long period of readjustment and expense is involved, if not outright liquidation and loss. Fixed bond interest charges thus inject an element of rigidity in the economic system which tends to intensify and prolong business depressions. If it can be demonstrated that the tax system has militated against sound corporation financial policy, sufficient justification might be found for tax reform in this respect.

The Net Tax Differential—1926-1942

Because of the complex nature of the tax system, its relative incidence on interest and common stockholders' equity cannot be easily determined, but the general direction and magnitude of the changes over a period of time can be indicated. No attempt will be made to estimate the influence of increasing individual surtax rates on common stock financing or the disparity introduced by preferred stock.

One of the principal factors offsetting the preferential treatment of bond interest has been the personal normal tax credit for dividend income. Although interest charges have been excluded from corporation taxable income, interest is fully taxable in the hands of the recipient; conversely, common stockholders have been subject to tax on their equity in corporation earnings, but dividends were exempt from normal personal income tax until 1936. While "double taxation" was only partially eliminated, the normal tax credit for dividends mitigated somewhat the discrimination against equity financing.

Prior to 1924 the tax system was relatively neutral toward corporate capitalization. At that time a reduction in the individual normal tax rate, in conjunction with a previous increase in the corporation rate (as shown by Table 1), shifted the balance definitely in favor of debt financing.[7] The differential between the corporation rate and the graduated individual normal rates for which tax credit was allowed reached 6.5—10.5 per cent compared with 2—6 per cent in 1921. By 1927 this differential attained a maximum of 8.5—12 per cent from which it gradually declined to 5.75—9.75 per cent in 1932-33.

The year 1934 marked a reversal of this trend when the normal tax credit on dividends was reduced from a maximum of 8 per cent to a flat 4 per cent. Elimination of the tax credit in 1936 made dividends fully taxable, and a rise in the corporation rate to 15 per cent gave a further incentive to debt financing. Successive increases in the corporation rate to 24 per cent in 1940, 31 per cent in 1941, and 40 per cent in 1942 further accentuated the discrimination against equity financing.

The impact of the tax system on common stockholders, however, was somewhat tempered by other factors peculiar to the corporation form. Although subject to "double" taxation of dividends at graduated rates, stockholders were in an advantageous position of postponing or avoiding personal income taxes by the retention of earn-

[7] Cf. the conclusions of the National Industrial Conference Board: "Taking into account the probable distribution of stockholding among the various income classes, it is a fair presumption that since 1924 corporation common stock as a whole has been discriminated against by the federal income tax system as compared with corporation bonds." *The Shifting and Effects of the Federal Corporation Income Tax*, vol. II (New York, 1930), p. 143.

TABLE 1

FEDERAL CORPORATION TAX RATES AND PERSONAL DIVIDEND TAX CREDIT, 1921-1942

Income Year	Corporation Normal Rate	Personal Dividend Tax Credit (Income Bracket, thousands)			Maximum Tax Differential
		\$1–\$4	\$4–\$8	Over \$8	
1921	10%	4%	8%	8%	2–6%
1922–23	12.5	4	8	8	4.5–8.5
1924	12.5	2	4	6	6.5–10.5
1925	13	2	4	6	7–11
1926–27	13.5	1.5	3	5	8.5–12
1928–31	12 [a]	1.5	3	5	7–10.5
1932–33	13.75	4	8	8	5.75–9.75
1934–35	13.75	4	4	4	9.75
1936–37	8–15 [b]	..	..	..	15
1938–39	12.5–19 [c]	..	..	..	19
1940	14.85–24	..	..	..	24
1941	21–31 [d]	..	..	..	31
1942	25–40 [d]	..	..	..	40

Source: Bureau of Internal Revenue *Statistics of Income for 1942,* Parts 1 and 2.

[a] Corporation and individual rates were reduced by one percentage point in 1929 by joint resolution of Congress.

[b] Excluding surtax on undistributed profits.

[c] Less 2.5 per cent dividend paid credit.

[d] Including surtax rate.

ings in the business. Reinvestment was further encouraged by the preferential treatment of capital gains when realized by sale of stock, and complete income tax immunity by its transfer through gift or devise. This form of discrimination, therefore, should have stimulated the internal financing of corporations except for the brief period of the undistributed profits tax in 1936 and 1937.

Trend of Capitalization, 1926-1942

Changes in Capital Structure.—Discrimination of the Federal income tax against equity financing should be reflected in the trend of corporation capitalization, other factors remaining the same. If changes in the ratio of debt to the total capital structure of American corporations have been consistent with the bias introduced by the tax system, a strong presumption of its influence may be established.

Between 1926 and 1932 there was a steady increase in the proportion of all corporation debt from 21.1 per cent to 26.1 per cent of total capital structure, as shown by Table 2. This period

TABLE 2

PERCENTAGE OF LONG-TERM DEBT TO TOTAL CAPITAL STRUCTURE,[a] SELECTED YEARS 1926-1942

Year	All Corporations	Manufacturing Corporations	Public Utilities[b]
1926	21.1	8.5	43.0[c]
1928	23.1	9.8	41.9
1930	23.8	10.1	41.3
1932	26.1	10.6	43.0
1934	25.5	9.6	43.1
1936	26.0	10.1	45.0
1938	26.2	11.3	44.6
1940	26.2	10.9	45.8
1942	24.4	10.1	42.4

Source: Bureau of Internal Revenue, *Statistics of Income* for corresponding years.

[a] Long-term debt includes mortgages, notes, and bonds with a maturity of one year or more. Capital structure includes fixed debt, preferred and common stock, surplus reserves and undivided profits (net).

[b] Includes transportation, power and light, and other utilities.

[c] Correction made for an apparent error of \$10 billion in *Statistics of Income for 1926.*

coincided with a fairly stable differential in favor of debt financing, which ranged from 7 to 12 percentage points, depending on the size of taxable income. It might be inferred from the over-all trend that corporations were taking advantage of the post-1924 incentive to debt financing. However, during the expansion phase which terminated in 1930, the over-all rise in debt ratio was very modest (about 12.5 per cent) despite a substantial increase in borrowing from $31.8 billion to $50.3 billion. Manufacturing corporations and public utilities followed divergent trends, with the debt ratio of the former rising appreciably and that of the latter actually declining. The aggregate increase in the debt ratio between 1930 and 1932 can be attributed to the relative rigidity of funded debt which accompanied the considerable shrinkage in capital and surplus accounts during the depression. It may be significant, however, that the proportion of all preferred stock declined from 11.3 per cent in 1926 to 9.0 per cent in 1930 (Table 3), almost exactly offsetting the increasing debt ratio during these five years. By 1932 the preferred ratio regained its 1927 level.

Following 1932 the over-all ratio of corporation debt to capital structure remained virtually unchanged at around 26 per cent, and actually declined to 24.4 per cent in 1942. The relative importance of manufacturing debt varied only slightly but that of public utilities increased moderately to 1940 and then declined to the level of the 1920's.[8] The remarkable stability of

TABLE 3

CORPORATION CAPITAL STRUCTURE, ALL CORPORATIONS, 1926-1942

Year	Amounts (billions of dollars)					Per Cent of Total	
	Bonds and Mortgages Payable	Preferred Stock	Common Stock	Surplus & Undivided Profits	Total	Bonds and Mortgages	Preferred Stock
1926	$31.8	$17.1	$67.5	$34.6	$151.0	21.1%	11.3%
1927	37.7	17.8	74.1	40.5	170.1	22.1	10.5
1928	42.9	18.5	77.2	47.1	185.7	23.1	10.0
1929	46.6	19.7	85.5	55.1	206.9	22.5	9.5
1930	50.3	19.1	87.1	55.1	211.6	23.8	9.0
1931	48.1	19.2	79.8	44.4	191.5	25.1	10.0
1932	47.2	19.1	78.4	36.1	180.8	26.1	10.5
1933	45.9	18.4	74.1	35.1	173.5	26.3	10.6
1934	48.6	20.0	85.0	36.7	190.3	25.5	10.5
1935	49.8	19.5	82.7	36.6	188.6	26.4	10.3
1936	47.0	18.6	78.1	36.8	180.5	26.0	10.3
1937	49.3	18.4	77.3	45.9	190.9	25.7	9.6
1938	50.3	18.1	74.8	44.6	187.8	26.6	9.6
1939	49.4	17.2	73.5	46.2	186.3	26.5	9.2
1940	49.2	17.1	72.3	49.0	187.6	26.2	9.1
1941	49.5	16.2	71.6	54.8	192.1	25.8	8.4
1942	45.0	15.5	65.8	58.3	184.6	24.4	8.4

Source: Bureau of Internal Revenue, *Statistics of Income for 1942,* Part 2, Table 18.

[8] Analysis of 201 industrial corporations by the S.E.C. showed an increase in the ratio of debt to total capital and surplus from 12 per cent to 14 per cent between 1937 and 1941. Data for power and light utilities showed a decrease in the debt

the corporation debt ratio during this decade is difficult to reconcile with the greatly enhanced tax benefits of borrowing that resulted from repeal of the dividend credit and rapidly increasing corporation rates. The statistical evidence, therefore, fails to confirm any measureable influence of tax policy on debt financing.

The implications of tax policy with respect to preferred stock are more clearly indicated. While the absolute amount of long-term debt remained practically constant between 1934 and 1941, the value of preferred stock reported declined from $20.0 billion to $16.2 billion, a reduction of 17 per cent. This was reflected in a drop in the ratio of preferred to total capital structure from 10.5 per cent to 8.4 per cent. This downward trend is clearly consistent with the greatly increased tax discrimination against use of preferred during this period. It seems likely, therefore, that the pressure of higher taxes on common stock equity was relieved in part by curtailment of preferred stock financing. It might be inferred from this development that, although the proportion of debt did not increase as expected, it remained higher than it would have if preferred stock enjoyed the same tax advantage. Many cases are on record of the shift from preferred stock to debentures.

New Security Issues.—Further evidence of the relative importance of stock and bond financing is provided by an analysis of new capital issues. Despite the current complaint over the shortage of risk capital, data covering the period from 1919 to 1947 indicate no definite trend in the proportion of bonds and stock issued by industrial companies. A recent study of corporation financing during these years concluded: "From these data it appears that the current ratio of equity financing, except for utilities, is not out of line with the average experience during the 1920's and 1930's, but is very considerably below 1929." [9] There has been little equity financing of public utilities in recent years, although the telephone industry has made very extensive use of convertible bonds.

However, the above conclusions must be accepted with some caution because of the development of long-term borrowing directly from commercial banks since the late 1930's. Such "term loans" do not enter into the record of new security issues. The importance of this type of borrowing is indicated by the following sources of net new capital financing in 1947: [10]

Bank loans, long term	$1.4	billion
Mortgage loans	0.7	"
New issues: Bonds and notes	2.8	"
Equity securities	0.9	"
Retained profits	10.1	"
Total	$15.9	"

Case Studies.—While the statistical record is negative, studies of individual cases tend to confirm the influence of tax considerations on the financial plans of corporations. Many such instances

ratio from 50 per cent to 46 per cent. This latter development may be explained in part by the pressure of the S.E.C. and state regulatory commissions to eliminate excessive debt. Securities and Exchange Commission, *Report on the Incidence of Taxation on Corporate Capitalization* (unpublished), April 19, 1943, pp. 1-2.

[9] Irwin Friend, "Business Financing in the Postwar Period," *Survey of Current Business*, March, 1948, p. 13.

[10] *Ibid.*

are supplied by records of the Securities & Exchange Commission [11] which indicate that the tax aspects of debt securities have been an important barrier, particularly in reorganizations, to the development of sound capital structures.

Generalizations based on the analysis of such individual cases, however, are of doubtful statistical validity. It is significant that most of the instances were drawn from recapitalization and reorganization proposals, primarily of public utility companies. In such cases there is ordinarily a strong pressure toward overcapitalization in order to preserve the interests of both creditors and stockholders, and an attempt to justify this action by savings on items such as taxes. The S.E.C. rightly takes much credit for an actual decline in the proportion of public utility debt since 1937,[12] and it is understandable that such reduction was resisted by many companies.

Factors Determining Capitalization

The financial plans of corporation are dictated by many factors. Although tax savings undoubtedly contribute to the final decision, they are subordinate to other more fundamental considerations. Investment bankers, for example, usually estimate tax savings to support their advice on a bond issue, but this is conceded to be a selling point rather than the primary basis of the decision.

The Market for Capital Funds.—Probably the greatest single factor dictating the use of bonds by large corporations, is the nature of the supply of capital funds. The vagaries of the investment market for equity capital are well known, but there is usually a dependable supply of debt capital from insurance companies, savings banks, and other institutional investors. In the year 1947 these institutions accounted for $3.4 billion out of $4.1 billion of new security purchases.[13] Legal restrictions of these institutions to investment in high-grade bonds, more than any other factor, shapes the pattern of American financing. The ready availability of this supply of capital greatly broadens the market for securities and enables new financing to be undertaken at a minimum cost. In some periods, however, the securities market is more receptive to equity securities than at other times. The proportion of stocks to all new capital issues in 1929, for example, was 62.1 per cent compared to 26.3 per cent in 1926; between 1945 and 1947 the proportion dropped from 52.6 per cent to 25.9 per cent.[14]

Cost of Capital.—The declining interest rate has provided another powerful stimulus to the use of bonds in the last two decades. Whereas the dividend yield of common stock at the present time ranges between 6.5 and 7.0 per cent, the yield of corporation bonds is about 3.0 per cent.[15] This low interest cost makes the advantages of trading on the equity by the use of bonds more attractive. The leverage thereby provided makes it possible to employ common stock in public utili-

[11] *Op. cit.*, pp. 7-24. See also W. D. Gay, "Public Utilities and Federal Income Taxes," *Public Utilities Fortnightly*, Aug. 27, 1942, for a summary of the Empire Gas and Fuel Co. case.

[12] *Ibid.*, p. 1.

[13] Friend, *op. cit.*, p. 11.

[14] *Ibid.*

[15] U. S. Department of Commerce, *Survey of Current Business*, May, 1949.

ties, for example, where the rate of return permitted on investment is not ordinarily sufficient to attract equity capital.

The cost of flotation of bond issues is known to be substantially lower than the cost of placing either preferred or common stock. Comparative commissions to investment bankers for the fiscal year ended June 30, 1947, are reported as follows by the S.E.C.:[16]

	Commission as % of gross proceeds
Bonds	0.9
Preferred stocks	2.8
Common stocks	9.3

Recent annual reports of the S.E.C. indicate a gradual decline since 1939 in the average commission for fourth grade corporation bonds from 2.3 to 1.4 per cent.

Retention of Control.—Bonds are frequently resorted to as a means of concentrating voting control in the hands of stockholders, with a minimum of investment. While classified voting stock is also employed, nonvoting stock is not always permitted by state law (e.g., Illinois) or must be given certain contingent voting rights to make it attractive.

Reinvestment of Earnings.—Largely offsetting the above pressures on debt financing is the internal financing of expansion requirements out of earnings. As indicated above, reinvestment of earnings is estimated to account for about $10 billion out of approximately $16 billion new capital financing in 1947. The magnitude of such reinvestment depends on the size of earnings after taxes, the rate of plant expansion, reserve requirements, the dividend demands of stockholders, and many other factors. The fact that these funds are already in possession of the corporation and represent " costless " capital creates a strong inducement to their utilization as an alternative to external financing.

Surplus and undivided profits naturally tend to increase in periods of expansion and to contract in periods of deflation. Table 3 indicates a substantial accumulation of earnings between 1926 and 1929 which raised the proportion of surplus to total capital and surplus from 23.0 per cent to 26.6 per cent. Losses of the ensuing depression reduced surplus to around 20 per cent of the total capital structure, from which it was restored to a peak of 31.6 per cent in 1942 as a result of economic developments since 1936.[17] While " unneutralities " of the tax system favored retention rather than distribution of earnings (except in 1936 and 1937), this influence was probably insignificant in the aggregate.

Safety and Stability of Earnings.—Capitalization is largely influenced by the inherent stability and adequacy of earnings of a business. Highly speculative ventures or those subject to unusual irregularity in earnings owing to cyclical changes and other influences are virtually precluded from issuing substantial amounts of debt, except occasionally convertible bonds. Sound management will ordinarily not be

[16] *Thirteenth Annual Report*, Appendix, Table 2.

[17] Data on surplus and undivided profits reported to the Bureau of Internal Revenue should be used with some caution because of the failure to segregate " capital " surplus from earned surplus. Paid-in surplus originating in subscriptions to no-par stock, as well as surplus resulting from reductions in par value, are thus included. The sharp increase in 1937 is especially questionable in view of the small net amount of undistributed profits of this year.

diverted by the realization of tax savings at the price of increased hazards of insolvency and possible bankruptcy. This explains the average low debt ratio of industrial corporations, which are exposed to more than ordinary cyclical risks. In 1937, for example, bonds were used by only 10 per cent of mining companies, 16 per cent of merchandising companies, and 22 per cent of manufacturing corporations listed with the S.E.C.[18] The discipline imposed by business management itself is reinforced by the conventional standards of the market in restricting corporation debt within safe limits of earnings and assets.

Effects of Eliminating Bond Interest Allowance

Revenue.—Total interest deductions in 1942 amounted to about \$2.5 billion; exclusion of interest paid by finance institutions such as banks and loan companies (but not real estate companies) leaves about \$2.1 billion potentially taxable.[19] After allowance for corporations with no net income and interest on short-term borrowing (reasonably treated as an operating expense), it is conservatively estimated that about \$1.5 billion of interest annually escapes the corporation income tax. This implies an annual tax saving of about \$600 million, at present rates. However, the net loss to the Government is somewhat less than this if account is taken of the greater amount of corporation income available for dividend payments. On the assumption of an average distribution of 50 per cent, the possible increase in personal income taxes would be \$100 million, leaving a net income tax loss of roughly \$500 million.

The above estimates assume no shifting of the corporation income tax. If corporation taxes are shifted in full there would be no real corporation income tax savings in the long run, but Government revenues would be more by the full amount of the tax on interest deductions. While the shiftability of an income tax remains an unsettled question, it still seems clear that the Federal Government sacrifices substantial revenues by the allowance of bond interest.

Impact on Stockholders.—The common stockholders would bear the burden of a corporation tax on net income before interest charges, unless and until business succeeded in shifting the increase through higher prices.[20] The immediate effect of a withdrawal of bond interest deduction might be to discourage investment in equity securities of many businesses financed largely by bonds because of the reduction in common stock earnings. The paradoxical result might be increased emphasis on borrowed capital to finance new expansion; but the reduction in the times-interest-earned factor might make such investments less attractive.

The greatest probability of shifting would be in the field of public utilities, where income taxes are commonly allowed as an element of cost in determining a reasonable return on investment.[21] The high proportion of

[18] Works Progress Administration, *Statistics of American Listed Corporations*, Part 1 (1940), pp. 189-191.

[19] Bureau of Internal Revenue, *Statistics of Income for 1942*, Part 2, Table 4.

[20] See Carl Shoup, "Incidence of the Corporation Income Tax: Capital Structure and Turnover Rates," *National Tax Journal*, I (March, 1948), 12-17.

[21] See J. V. Burkhead, "The Changing Incidence of Public Utility Taxation," *Journal of Land and Public Utility Economics*, November, 1939.

funded debt in this industry would make such an allowance imperative in order to protect present investment and to attract new capital. Since public utilities account for approximately 50 per cent of all corporation bond interest payments, a tax increase of this nature would probably be reflected in a greater rise in prices than an ordinary increase in the normal or surtax rate. Common stockholders might, nevertheless, bear the brunt of such an increase in corporation taxes until rate adjustments were granted and the tax shifted gradually in other areas, if at all.

Effect on Bondholders.—Complete reversal of policy with respect to the deduction of bond interest should not be undertaken without consideration of its impact on existing corporation debt. Sudden withdrawal of the privilege might seriously impair the safety of bond investments in many instances. A corporation which is just earning bond interest over a period of time, for example, might be forced into bankruptcy and reorganization (or liquidation) by the imposition of a tax rate of, say, 40 per cent. The lowering of safety factors in other corporations would also have an unfavorable reaction on market values. Thus the effect may be inequitable in hitting hardest those companies least able to pay. Unless some fair relief provision can be devised, the disallowance of bond interest deduction (if enacted at all) should be confined to future issues rather than those already outstanding.[22]

Tax Avoidance.—A problem of equity also arises in the treatment of corporations employing alternative legal contracts in hiring capital. The most obvious device is the long-term lease which has been a conventional method of financing railroad equipment and other railroad property. It also represents a more recent development in the industrial field, where buildings have been sold to insurance companies and other investment institutions and rented back on a long-term basis. By this arrangement corporations not only secure a financial advantage in eliminating debt from their capitalization, but also frequently obtain a tax advantage which would be made even more attractive with the disallowance of bond interest charges.

If only interest on long-term debt were included, an inducement would be given to short-term borrowing. Although interest on short-term loans might properly be treated as an operating expense, such loans are frequently a permanent liability because of their continuous renewal and refinancing. It would be difficult, therefore, to draw an arbitrary line of, say, one year without encouraging undue avoidance by potentially dangerous short maturities.

Conclusions

The complex forces governing the demand and supply of corporation capital make it impossible to isolate the discriminatory effects of the tax system on the capital structure of industry. With respect to the supply of funds, legal restrictions on investment institutions have largely influenced the use of bonds, while the reinvested earnings of business itself have probably been the greatest source of equity capital. Since equity securities are purchased primarily by individual investors, the temper of the securities market is an important determinant. Although the terms of

[22] G. O. May suggests an alternative of making the allowance on existing debt contingent upon concurrent debt reduction, but this appears impracticable. "Corporate Structures and the Federal Income Tax," *Harvard Business Review*, Autumn, 1943, p. 18.

new capital issues are influenced by the available sources of supply, the corporation financial plan is designed to maximize the return to the controlling stock interests consistent with the maintenance of adequate safety and liquidity. The amount of trading on the equity is thus limited by the self discipline of business management and circumscribed by the judgment of the market (as well as regulatory commissions). The hazards to insolvency are frequently so great as to preclude any use of fixed charge contracts. Good financial policy, however, provides for flexibility in adjusting the financial structure to changing economic conditions.

The greatly increased tax benefits of deducting bond interest have significantly altered the balance in favor of debt financing. Although the choice of bonds over preferred stock, in many instances, is undoubtedly influenced by their tax advantage, tax incentives have not been sufficiently strong in general to result in an unbalanced capital structure of industry. Both the amount and relative importance of bonds remained remarkably constant during the entire decade 1932-1941 when the tax differential was enlarged. Tax pressure is evidenced, however, in the declining importance of preferred stock. The net result was to enhance the position of common stock equity. It would, therefore, be difficult to justify the elimination of bond interest deduction for income tax purposes on the basis of its alleged discriminatory effects alone.

Repeal of the bond interest deduction can be defended on logical grounds as elimination of an arbitrary differentiation of corporation income which has no rational conceptual basis. Income tax revenues would also be increased by the inclusion of bond interest in the corporation tax base. As a practical matter, however, such a step would jeopardize the safety of many bond issues and intensify the burden on the common stockholders. Although the tax might be shifted in time, this could be accomplished only by restricting new investment and production and with uneven effects on different industries and businesses. If taxation of interest were limited to future issues, the distribution of its incidence would be arbitrary and capricious. Moreover, the possibilities of avoidance would create serious problems of equity and enforcement.

The discriminatory effects of the present Federal tax structure transcend the internal inconsistencies of the corporation tax law. To eliminate these internal " unneutralities " by the inclusion of bond interest in the tax base would only intensify and perpetuate the inequities of the existing system. To follow the alternative course, allowance for preferred dividends would neutralize the choice of bonds and preferred stock and provide some relief to common stock. But this step would still discriminate against equity financing and would open new avenues of avoidance. To pursue this course to its logical conclusion would allow deduction of common stock dividends, as well, and tax only undistributed profits in the hands of the corporation. Removal of the present " double taxation " of common stock dividends, in one way or another, appears to offer the best solution but is not without its own peculiar set of problems.[23]

[23] See G. E. Lent, *The Impact of the Undistributed Profits Tax* (New York: Columbia University Press, 1948).

THE 1948 AUDIT CONTROL PROGRAM FOR FEDERAL INDIVIDUAL INCOME TAX RETURNS

MARIUS FARIOLETTI *

THE ADVISORY GROUP appointed by the Joint Committee on Internal Revenue Taxation to investigate the Bureau of Internal Revenue recommended that random sampling be employed as one of several methods of selecting returns for examination and that satisfactory statistical measures of adequacy of enforcement be developed for the purpose of improving the management and effectiveness of audit programs.[1]

* The writer is a member of the Management Staff, Office of Assistant to the Commissioner of Internal Revenue. While the writer is responsible for the preparation of this paper, he would like to point out that its outlines are largely the product of group research and thinking. Particular credit should be given to Mr. J. R. Turner of the Management Staff and Mrs. Lillian H. Phillips of the Statistical Division. See also *Proceedings of the Forty-First Annual Conference on Taxation,* National Tax Association 1948: George W. Mitchell, "Tax Administration: Objectives, Methods, and Tests of Adequacy," pp. 51-53; Thomas C. Atkeson, "Management Staff of the Bureau of Internal Revenue—A Progress Report," pp. 83-84; Richard W. Nelson, "Aspects of the Audit Program of the Bureau of Internal Revenue," pp. 111-112.

1 *Investigation of the Bureau of Internal Revenue,* Report to the Joint Committee on Internal Revenue Taxation, pursuant to sec. 1203 (b) (6), Revenue Act of 1926, by the advisory group appointed pursuant to Public Law 147, 80th Cong. (Washington: Government Printing Office, 1948), pp. 23, 26, 27. See statements to the Joint Committee by the Treasury Department and Commissioner of Internal Revenue with respect to the report (Washington: Government Printing Office, 1948). See also "Investigation of the Bureau of Internal Revenue," *National Tax Journal,* I (September, 1948), 264-265.

In response to these recommendations, the Bureau of Internal Revenue has inaugurated a new supplemental program of sample selection of individual income tax returns for field investigation for 1948 and subsequent years. This paper, which is in the nature of a prospectus, describes the general background and outlines of the program. The problems pertaining to the proper selection of tax returns for investigation and other aspects of the effective management of audit programs are persistent and unruly and require continuous study. Consequently, the outlines of the 1948 Audit Control Program should be viewed only as a beginning toward developing aids to improved management of mass tax enforcement problems. They will undoubtedly change with experience, and comparable projects eventually will be developed with respect to other Federal taxes.

The Problem

Before specifically discussing the 1948 Audit Control Program, it is desirable to review a few of the relevant facts about the size and shape of the individual income tax. In the 1939 fiscal year this tax was responsible for about $1 billion or one-fifth of the total internal revenue. For 1949, the individual income tax collections are

expected to be almost $19 billion or more than two-fifths of the internal revenue.[2]

The rise of the individual income tax to its current prominence is attributable to three factors. First, the increases in personal incomes from about $73 billion in calendar 1939 to about $214 billion in 1948 contributed materially to the increase in collections.[3]

Second, the large increases in tax rates added materially to the greatly higher individual income tax yield.[4] These high tax rates have also contributed to the difficult administration problems involved in controlling tax avoidance and stopping tax evasion.

Third, drastic reduction in the level of personal exemptions which occurred after 1939 is the primary source of the mass tax enforcement problems which face the Bureau today. In other words, when we couple the fact that full employment means roughly 60 million civilian workers with the fact that exemptions are now $600 per capita, it is readily understood why over 53 million individual income tax returns are expected to be filed during fiscal 1949. Compare this figure with the 6.5 million returns filed in fiscal 1939, and we should clearly hear the shouting from the growing pains in the collectors' offices.

The above indicated changes are more clearly understood than the more hidden changes which occurred in the proportions of the tax paid by different income classes. Yet these changes in proportions are crucial to understanding how the difference between the postwar and the prewar individual income taxes affects tax enforcement procedures.

In 1939, over six-tenths of the individual income tax liability was paid by well-to-do persons with incomes of more than $25,000 a year. But, as the tax base was broadened by lower exemptions and full employment incomes, and as the tax yield was further increased by higher tax rates, the relative importance of these well-to-do persons dropped. In 1948 they are expected to account for only three-tenths of the tax.

Returns with incomes of less than $5,000, which in 1939 numbered less than 7 million and accounted for 10 per cent of the total individual income tax liability, have been the primary source of growth; in 1948 they are expected to be 50 million in number and to account for about one-half the tax.

The significance of these facts about changing proportions is that millions of individual income tax returns would have to be audited under the postwar income tax to cover about the same proportion of tax liability as was covered by audit before the war.

Before the war, the audit of 14,000 tax returns with the highest incomes would have accounted for one-half of the tax liability reported. However, to account for one-half of the 1948 tax liability would require the auditing of over 2 million returns. (See Table 1.)

If the 700,000 returns with the highest incomes had been audited before

[2] For 1939, see *Annual Report of the Commissioner of Internal Revenue*, 1939, pp. 1-2; for 1949 estimate, see *Annual Report of the Secretary of the Treasury*, 1948, p. 57.

[3] Release OBE-201, February 2, 1949, Office of Business Economics, Department of Commerce.

[4] For a summary of changes in rates and exemptions, see "Comparison of Individual Income Tax Effective Rates and Liabilities, Revenue Acts of 1913-1945," *Treasury Bulletin*, February, 1947, pp. A-5—A-15.

TABLE 1

Smallest Number of Tax Returns Required to Account for Stated Percentage of Tax Liability, 1939 Compared with 1948 (est.)

Percentage of Total Tax	Number of Returns Required 1939	1948 (est.)
10	150	15,000
20	750	70,000
30	2,400	200,000
40	5,900	650,000
50	14,000	2,200,000
60	32,000	5,600,000
70	74,000	10,800,000
80	185,000	17,400,000
90	674,000	26,000,000

Source: 1939—Derived from *Statistics of Income* for 1939, Part 1.

1948—Derived from Treasury Department release, "The Revenue Act of 1948," April 14, 1948.

the war, over nine-tenths of the reported tax liability would have been covered. If nine-tenths of the reported 1948 tax liability were to be examined, about 26 million tax returns would be involved in the audit program.

From a practical auditing standpoint, the 6 to 7 million low-income returns might well have been largely ignored in 1939. Under the present broad-base income tax, which is one likely to endure for many years, the half-a-hundred million low-income returns cannot be ignored since they represent one-half of the total individual income tax liability.

Mass Methods of Tax Enforcement

A mass income tax requires mass methods of tax enforcement. This is not a new idea, but it has not yet been fully exploited.

The problems of administering a mass income tax have been materially lessened by the withholding tax. In turn, this tax has necessitated annual reconciliation of tax prepayments with final tax liability and the issuance of millions of refund checks. This is a big administrative task. Yet, in view of the large increase in distraint warrants, issuing tax refunds is probably easier than collecting balances due.

In addition, the simplified tax table, introduced in 1944, and the standard deduction have reduced the areas requiring audit. How much error has been eliminated or reduced by the collectors' computation of the annual tax liability and reconciliation for more than 20 million taxpayers, nobody knows. Yet, it is fair to say that the work involved in computing the final tax liability and the refunds and balances for these taxpayers is not wholly additional work. If these taxpayers made their own computations and claims, such items would have to be checked for accuracy of arithmetic, and many errors would be found.

Few taxpayers probably appreciate fully the really stupendous achievement of the Bureau of Internal Revenue in quickly adjusting itself to the enormous increases in work-loads, most of them seasonal in character, required to handle the more than 50 million individual income tax returns. However, in retrospect, it seems clear that without the pay-as-you-go and simplification programs this job simply could not have been well done, if done at all. These factors are basic to adequate enforcement of a mass income tax. But they are just the beginning—the framework which makes feasible a high level of mass, voluntary compliance. Other mass enforcement means must be employed to attain and maintain a level of voluntary compliance consistent with the spirit of the tax laws. One of

these is already at hand. It involves the mass matching of tax prepayments and information documents which annually provides more leads for field investigation than can now be handled. But other methods must also be found.

The Audit Control Program for Mass Enforcement Purposes

Better knowledge than is available today about the masses of income taxpayers is required both to apply present methods of tax enforcement more effectively and to discover new mass enforcement techniques.

For example, the claiming of unallowable exemptions has been an important method of tax understatement by some wage earners filing W-2 returns (now 1040A). However, it is not known whether this involves 5 per cent of such taxpayers or 25 per cent. Moreover, it is not known whether this problem is either less important or more important with regard to the millions of wage earners filing the 1040 type of return. Furthermore, the importance of excessive claiming of exemptions in comparison with the understatement of income by wage earners is also unknown. Of course, no one should expect the understatement of income to be relatively important in this taxpayer area, since wage earners typically do not have much, if any, income other than their wages. However, a high frequency of understatement of small amounts of income by many taxpayers may in the aggregate be as important as a low frequency of excessive claiming of exemptions. It is fair to conclude that, although the general areas of tax enforcement needs and difficulties are well known, existing knowledge is too often vague and sometimes biased. Improved management requires that tax administration knowledge be organized into more objective and specific forms.

A sample audit program is the most practicable method of converting available knowledge about tax enforcement needs and problems into objective and specific quantities and proportions. Such a program has been adopted with respect to the 1948 individual income tax returns. We shall now indicate the kinds of information and enforcement results expected from this program.

Total Audit Work Load.—The most important first-year product of the 1948 Audit Control Program will be the determination of the probable total audit work load (that is, the number of returns with error) connected with the 1948 individual income tax returns. In other words, with the audit results supplied by the field investigations, it will be possible to estimate the total number of 1948 individual income tax returns that contain error in tax liability, and the magnitude of tax adjustments involved if a complete audit of the 1948 returns were made with the same quality of investigating officers as were assigned to the Audit Control Program. The returns with error will be further divided into those that involve additional assessment and those that involve overassessment. This information will be provided not only for the United States as a whole but also for collectors' districts and revenue agents' divisions.

For the first time, Bureau executives will have before them basic estimates indicating the over-all size of the field enforcement problem. The proportion

of taxpayers who filed "no change" returns will indicate the millions of citizens whose honesty plus the Bureau's educational and enforcement efforts have combined to produce a level of voluntary compliance consistent with the spirit of the tax laws. These are the good "customers" whose goodwill and morale must be maintained, for their basic willingness to comply voluntarily with the tax laws is a great national asset whose capital value, in large part, has been entrusted to the Bureau of Internal Revenue.

It is important that everybody realize that this is a depreciable asset. Like any depreciable asset, this willingness to comply with tax laws requires outlays to maintain and conserve it. Basically, enforcement of the tax law is for the benefit of these citizens. The relative importance of this group, the amount of tax they pay, and other characteristics need to be known. These things should be determined year by year, for if it is known whether this group is increasing or decreasing in relation to all taxpayers we can tell whether tax administration is improving or deteriorating. This information is not available today. It is suspected that the effectiveness of Federal tax administration may have decreased substantially by prewar standards.

The information on taxpayers who unwittingly determined their tax liability to be larger than the amount owed will point to equally honest taxpayers whom the Bureau must help. These taxpayers may be added to the first group if they are reached and assisted in handling their financial responsibilities to the Federal Government. However, some of these taxpayers are potential additions to the deficiency group, if they discover their errors without Bureau help and, subsequently, feel that their interests were not adequately safeguarded during years of self-overassessment. Today the relative importance of this group of taxpayers is unknown. Only when the results of the Audit Control Program show the proportionate size of this overassessment group decreasing without inflating that of the deficiency group will there be indications that this area of tax administration is being handled effectively.

Finally, comparable information on the third group of taxpayers—those who understated their tax liabilities—will be obtained. Like the tests in the other two groups, comparison of the changing relative importance of the deficiency group will help to indicate whether the problems of tax enforcement are being met effectively.

If tax officials are provided with the kind of information sketched above for the United States as a whole, they will be better able to judge the over-all size of their job and plan accordingly. Comparing current efforts with the size of the job to be done will indicate the gap that must be filled and should permit better budgeting of available funds as well as better budget planning.

Similar information for collectors' districts and revenue agents' divisions should help these officials to improve their local and regional enforcement planning.

After this type of information has been obtained for several consecutive years, indications of increasing or decreasing effectiveness of tax enforcement will emerge, not only for the

United States as a whole, but also for the separate geographical and audit authority areas.

Selecting Returns with Error.—Once the over-all dimensions of deficiency and overassessment cases are determined, the practical problem must be faced of finding them by efficient methods. The recent transfer of all screening or classification work to the field offices should help to improve the efficiency of this work.[5] But even experienced field men must too often guess as to which of the millions of returns are in error and most in need of examination in view of the limited enforcement effort available. What will the Audit Control Program contribute to the better handling of this difficult problem?

It will provide information on the frequency of different types of errors found on returns as the result of field examinations. Thus, for both overassessment and deficiency cases, it will be feasible to estimate the frequency and relative importance of the major sources of tax change in the areas of income, personal deductions, and exemptions. Moreover, detail will be obtained about the frequency of specific kinds of error within these three broad areas. In the income area, for example, it will be feasible to identify the specific income item (such as wages, dividends, interest, etc.) primarily responsible for the income error. In addition, it will be possible to determine whether such income item was not reported at all or the receipts misreported, and whether related deductions were misreported. When this kind of detailed information is associated with type of return filed and broad income classes, we may find that patterns of error exist. Where these patterns of error are clearly identified with type of return or size of income, they may be helpful in identifying returns likely to contain error. But it should be made clear that discovery of effective rules for more efficient classification is a hope and not a certainty. It seems reasonable to expect, however, that such detailed information will be very useful in learning the tax-anatomy of troublesome taxpayers.

The Audit Control Program will also provide better information about areas of aggravated noncompliance. It is expected that estimates of the relative importance of noncompliance among different kinds of businesses and professions will be feasible. With more specific knowledge about aggravated noncomplicance areas it will be easier to make good judgments as to the amount of effort that should, for example, be directed toward certain professions as compared with certain businesses. Here, too, obtaining this kind of information over several years will indicate which areas have been raised to adequate standards of compliance and which apparently continue to need concentrated enforcement activity. However, desirable though it may be, the 1948 sample will not permit these estimates to be made for each of the separate collector's and agent's areas.

Maximizing the Effectiveness of the Written Word.—The information on different types of errors will also indicate where instructions need to be emphasized and tax return forms improved in the attempt to maximize the use of the written word in raising the

[5] See recommendation respecting "Bureau returns" by the Advisory Group, *op. cit.*, p. 41, and the Commissioner's statements, *op. cit.*, item 8 (b), p. 12.

level of voluntary compliance by taxpayers. It is generally known that a substantial proportion of the tax errors made are attributable to imperfect taxpayer knowledge as to rights and duties in the tax field. Although very considerable progress has been made since 1944 in improving tax return forms and instructions for the mass of individual income taxpayers, we should continually look for further improvements in this area. The Audit Control Program can point up the items of reporting which need attention.

Sample Audit Program, a Mass Enforcement Technique.—The selection of a representative sample of income tax returns for investigation is itself a method of classification which may be viewed as a mass enforcement technique. That is, an important enforcement effect of a sample audit program is its impact on mass psychology. Letting taxpayers know that thousands of individual income tax returns will be selected for field investigation by random methods will induce many of them to be more careful and less willing to err, for they can no longer feel that a practiced wit and shrewdness poured into tax returns will soothe the strained eye of the tax collector. Thus, the cost of a sample audit program should not be allocated entirely, or perhaps even in large part, to the cost of improving management techniques alone, for important indirect enforcement effects are likely to result.

In considering the cost of the sample audit program, it should also be realized that some of the returns selected by the random method would, in any case, have been selected for field investigation by the other methods. This is particularly true among the agents' cases, where the proportions of returns filed which are selected for investigation are much higher than among the collectors' returns. In addition, the random sample method of selection will discover errors on returns that would not have been selected for field investigation by other procedures.

For these reasons, the sample audit program is expected to pay its own way in terms of better tax enforcement, and the information obtained from the program may be viewed as a low-cost product.

Sampling, a Tool of Management

Sampling is more than a statistician's gadget. It is a twentieth century tool of management used to handle mass production and management jobs realistically and effectively. Sampling is a relatively precise method of estimating group characteristics and patterns of characteristics at low cost. More than that, a properly designed sample will also permit the determination of the range of error contained in the estimates of the group characteristics. The list of business concerns employing sampling methods for production control includes most of the important companies in the United States. Other private and public organizations use sampling methods to determine the characteristics of markets or consumers. In tax administration, sampling methods can be used profitably to learn more about the market—the taxpayer—and the quality of the product—the success with which he has been taught and induced to comply with the tax laws.

Description of the 1948 Audit Control Sample

The 1948 sample audit program has been set at 150,000 returns. This size was determined both on the basis of administrative considerations, such as the availability of investigating officers, and statistical considerations involving reliability of estimates. In turn, these returns have been allocated approximately 100,000 to collectors' returns (roughly, those with adjusted gross incomes of under $7,000), and 50,000 to revenue agents' returns (those with adjusted gross incomes of over $7,000). The 150,000 cases have also been allocated by type of return in the collectors' area and by broad income sizes in the agents' area with the view to obtaining adequate representativeness within the over-all limits of the sample size.

The selection of the sample is controlled by drawing it in Washington rather than in the field. The Statistical Division of the Bureau will select the audit control sample from the *Statistics of Income* sample which it has been successfully drawing by random methods for some time. By selecting the audit sample from the statistical sample, the most practical means are utilized for avoiding bias in the selection method and, at the same time, the process stays within established administrative procedures for handling tax returns. The basic method of sampling tax returns by serial numbers geared to administrative procedures avoids selection biases. This method provides assurance that each type of return, whether nontaxable or taxable, or whether it involves a tax credit, a refund, a balance due, or no year-end adjustment, will be drawn in accordance with its proper weighting among all returns filed.

This method of selecting the audit control sample will permit the Bureau's statisticians to calculate the sampling errors for any statistic which is derived from this study. For example, if among the sample of taxpayers filing 1040A returns as many as 20 per cent are found to have claimed too many exemptions, the statisticians will be able to state that, insofar as sampling is concerned, this information will not be off more than 3 per cent either way. But if only 1 per cent of these taxpayers are found to have claimed excessive exemptions, the error will rise to 16 per cent. In other words, where an error is found to have occurred only 1 per cent of the time among 1040A returns, it can be reasonably expected that the frequency of this error which would have been found if all 1040A returns had been investigated is between 0.8 per cent and 1.2 per cent.

These sampling errors are insignificant when compared with the present uncertainty of estimates owing to the lack of information. Today no one knows the proportions of erroneous claims for exemptions.

Efforts to control error have not, of course, been limited to sample design. Some of these controls are indicated below.

First, each return will be accompanied by a specially designed check sheet which will serve as the document on which the investigator reports the results of his examination for tabulation.

Second, regional conferences and other methods are being utilized to ex-

plain objectives and to raise questions respecting methods and procedures. This method of contacting the field organizations prior to the actual launching of the investigations permits the development of instructions based on practical problems and issues raised by many experienced field operators.

Third, available information documents are to be associated with the returns, prior to their assignment for investigation.

Fourth, only experienced personnel fully capable of handling the types of returns selected are to be assigned to investigate the returns included in the program.

The Audit Control Program will incorporate certain errors which it will probably not be feasible to segregate or to estimate. Some taxpayers will be more or less successful in concealing information necessary to the correct determination of tax liability. This type of error does not derive from the design or nature of the sample, since it would exist even if every taxpayer who filed a return were to be investigated. However, this type of error is not considered to be important for purposes of the program, since it is proposed to estimate, not the errors that taxpayers make, but the errors that experienced Bureau of Internal Revenue investigators would find if all of the returns of taxpayers were audited. It is known that it will never be possible to find all of the errors made by taxpayers. However, there is every reason to believe that the Audit Control Program will be an important step toward the solution of our tax enforcement problems.

EXCHANGE OF INFORMATION FOR PURPOSES OF FEDERAL, STATE, AND LOCAL TAX ADMINISTRATION *

THERE IS general adherence to the view that the tax administrative activities of Federal and state authorities should be coordinated to the greatest extent feasible. Everyone favors the lowest possible ratio of administrative costs to tax collections, consistent with the maintenance of adequate standards of enforcement. Everyone desires to hold the taxpayers' costs of compliance at minimum levels. And everyone believes that coordination of administrative efforts represents progress toward these objectives. Notwithstanding this consensus in theory, experience indicates that attempts to expand the area of coordination at the operational level frequently encounter a variety of practical difficulties. Nevertheless, some significant advances have been made, and others are in prospect.

There follows a review of the more important ways in which the Treasury Department and state-local authorities are collaborating in the administrative area.

* Prepared by the Bureau of Internal Revenue in connection with the exploratory conference concerning intergovernmental tax problems and fiscal relations held by the Secretary of the Treasury with state and local representatives, April 21-22, 1949.

Inspection of Federal Income Tax Returns by State Officials

By law, Federal income tax returns are open to inspection by state tax officials for use in administering the tax laws of the state, or for the purpose of obtaining information to be furnished local tax officials for use in administering the tax laws of a political subdivision of the state. The application for inspection of returns is made to the Commissioner of Internal Revenue by the governor over the seal of his state, specifying the tax law involved in his request, designating the classes of returns, and listing the names of the state tax officials who are to have access to the returns. The inspection is authorized by formal reply of the Commissioner. It may be noted that local assessors of taxes do not have access to the original copies of Federal income tax returns. Copies of such returns are made available to them through the appropriate state officials. The inspection privilege granted to states is based solely on the use of such information for tax purposes only by the state.

By regulation, the Commissioner in his discretion may furnish the bases of the changes made in cases where the Bureau of Internal Revenue has determined the tax liability to be different

from that reported by the taxpayer. In a so-called tax "evasion" case which has been finally closed by the Bureau, the adjusted net income figure is furnished in addition to information contained in the return as filed. As a matter of policy, information pertaining directly to possible prosecution for fraud is not disclosed to state officials in order to avoid all possibility of premature disclosure of evidence that might handicap the presentation of the Government's case in court. Other considerations are also responsible for this policy, among which are the revealing of confidential sources of information and the disclosing of details of business operations and personal affairs of individuals other than the taxpayer.

Many requests are received for photostatic copies of the returns of specified persons or corporations. Other requests are received for permission to inspect, both in Washington and in the offices of collectors of internal revenue, the income tax returns for specified years of all persons subject to the tax laws of the state who have filed returns with the Federal Government.

A variety of information is furnished in accordance with the particular needs of the individual states. To illustrate: abstracts are prepared according to specifications such as the following:

1. All changes in net income, whether increases or decreases;
2. All increases in net income;
3. Increases in net income above state exemption levels;
4. Increases in net income above amount set by the state as productive of state tax;
5. Item by item changes made by revenue agents according to lists furnished of particular items, such as interest, dividends, royalties, inventories, etc. Such requests are received from states that have intangible tax laws.

As of December 31, 1948, the transcript service had been extended to twenty-eight states, as follows:

Alabama	Missouri
Arkansas	Montana
California	New Mexico
Connecticut	New York
Delaware	North Carolina
Georgia	North Dakota
Idaho	Ohio
Iowa	Oklahoma
Kansas	Oregon
Kentucky	Pennsylvania
Louisiana	Utah
Maryland	Vermont
Massachusetts	Virginia
Mississippi	Wisconsin

Of this number, three states desired information from corporate returns only, six from returns of individuals only, and nineteen from both corporate and individual returns. Most of the states obtained the desired information in the form of abstracts or transcripts of returns that are prepared by the Bureau, and for which the states pay on a time unit basis. The present charge is $1.50 per hour per Bureau employee. During the calendar year 1948, 87,618 transcripts were supplied, and for these services the Bureau received $14,628.81 from the states.

In addition to utilizing this transcript service, nine states sent their own representatives to Washington or to collectors' offices either to microfilm or to make hand transcripts of returns, as follows:

Microfilm	*Hand Transcriptions*
Alabama	Delaware
Georgia	Florida
Iowa	New Hampshire
Mississippi	New York
Ohio	

These methods of obtaining information are available to the states without cost to them, and consequently the Bureau does not have records as to the number of returns involved. It is evident, however, that the number is far in excess of the total number of transcripts prepared by the Bureau.

The efforts of the Bureau of Internal Revenue in affording the states an opportunity to inspect Federal returns represent a very substantial contribution to state tax administration.

Inspection of Federal Social Security Tax Returns

State inspection of Federal income tax returns is conducted under clear statutory authorization and in accordance with definite, established procedure. A similar situation obtains in regard to state inspection of one class of Federal social security tax return, namely, Form 940, the annual return of employers of eight or more employees under the Federal Unemployment Tax Act. The Federal statute has specifically authorized such inspection from the inception of the Federal-state unemployment insurance program, and a number of states have availed themselves of this privilege over the years in connection with their administration of state unemployment compensation laws.

The situation has been somewhat less developed in respect to state inspection of quarterly returns on Form SS-1a of employers of one or more employees under the Federal Insurance Contributions Act. The reasons for this can be explained by reference to the circumstances surrounding the origin of this law. This act, as well as the Federal Unemployment Tax Act, both now incorporated in the Internal Revenue Code, were derived from the tax provisions of the Social Security Act. The annual return method of collection of the unemployment tax was expressly prescribed by the statute, and coordination between Federal and state administrators was clearly part and parcel of the unemployment insurance program. As previously indicated, the original act specifically authorized state inspection of the annual Federal unemployment tax returns, Form 940, of employers of eight or more employees.

The Social Security Act, on the other hand, was silent as to inspection of the returns on Form SS-1a under the social security retirement program. There were probably several reasons for this. First, the statute gives wide discretion to the Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury, to provide by regulations the manner of collection of these taxes from employers and employees, including methods other than the return method. At the time of the enactment it was not even known that the return method would be used. Second, the old-age retirement program was solely a Federal Government undertaking, the states not being called upon to participate. A probable additional reason for the silence of the Federal statute as to state inspection of these returns on Form SS-1a was that it was unknown at the time of enactment in

1935 that so many state unemployment insurance laws would cover employers having fewer than eight employees. In other words, it may have been felt that the provision in the law for inspection of the Federal returns of employers of eight or more would suffice.

With so many state laws and with more than half of them now covering employers having fewer than eight employees, it was natural that there would be some demand for inspection of the quarterly returns of employers of one or more, as a check by state officials for employer compliance with the state laws.

It was against this background of circumstances that within the past year the Treasury Department and its Bureau of Internal Revenue re-examined their previously uniform position that, in the absence of specific statutory authorization, no inspection of the quarterly returns on Form SS-1a could be permitted.

At that time there was pending in the Bureau a request of the State of New York to inspect returns on Form SS-1a in order to ascertain whether all employers of four or more persons, as disclosed by such returns, were registered with the State Division of Placement and Unemployment Insurance. A reply granting such request was sent to New York on August 10, 1948.

Subsequently, and based on the action taken in the test case of the New York request, the procedure for obtaining inspection of returns on Form SS-1a was published for the benefit of all state unemployment compensation commissions. This was accomplished by Mimeograph No. 6310, dated September 27, 1948, signed by the Commissioner and approved by Acting Secretary Lynch. So far as the Treasury Department is concerned, the inspection may be permitted only as to the tax portion of the Form SS-1a, which is retained in collectors' offices. The tax portion of the returns contains items covering name and address of the employer, total number of employees listed on the Schedule A portion of the return, total taxable wages paid to all employees, and amounts of tax. The Schedule A portion of Form SS-1a, listing the names, social security account numbers, and wages of the individual employees, cannot be made available for inspection in collectors' offices, because that portion of the return must be forwarded as expeditiously as possible by collectors to the wage records offices of the Social Security Administration in Baltimore.

Information to States Regarding Compensation of Federal Employees

It is the established Federal policy to furnish information with respect to compensation paid Federal employees to the states and other taxing authorities which impose taxes on compensation for personal service. This is done in the main by preparing copies of the Form W-2 (statement of tax withheld by employers) and the Form 1099 (information return of wages and other income not subject to withholding) for transmittal to state or local agencies that request such aid.

The rules and procedures under which information concerning compensation of Federal employees is to be furnished are set forth in Budget Circular No. A-38, dated December 14, 1948, and addressed by the Director of the Budget to the Heads of Executive Departments and Establishments. Any

taxing authority receiving information under the provisions of this budget circular is invited to furnish copies of its income tax law and regulations to the various Federal agencies and offices affected, as an aid to employees who seek to determine whether they are liable for the tax, and also to assist the officials of such Federal agencies in arranging all possible procedural short-cuts that may save time and expense in preparing the information desired.

In certain instances, it may be necessary for a Federal agency to give information on its employees to more than one taxing authority. This situation may arise if tax is imposed both at place of residence and at place of employment. It also may arise if a tax is imposed by each of two overlapping jurisdictions; for example, a state and city (as in Ohio) or a city and a school district (as in Pennsylvania).

The states and other taxing authorities that have requested information on compensation paid to Federal employees are the following:

States

Alabama	Minnesota
Arizona	Mississippi
Arkansas	Missouri
California	Montana
Colorado	New Mexico
Delaware	New York
Georgia	North Carolina
Idaho	North Dakota
Indiana	Oklahoma
Iowa	Oregon
Kansas	South Carolina
Kentucky	Utah
Louisiana	Vermont
Maryland	Virginia
Massachusetts	Wisconsin

Other Taxing Authorities

District of Columbia	Springfield, Ohio
Territory of Hawaii	Toledo, Ohio
Louisville, Kentucky	Philadelphia, Pennsylvania
St. Louis, Missouri	

Cooperation and Exchange of Information in the Excise and Estate and Gift Tax Areas

The procedure for the inspection of Federal estate and gift tax returns by state officials is set forth in Treasury Decision 4929, and procedure in the case of excise tax returns is governed by Treasury Decision 5138. In accordance with these regulations, the Bureau of Internal Revenue has granted all proper requests to examine the returns of individually named taxpayers. The regulations do not contemplate blanket inspections by state officials of all returns of these types.

Many officials believe that more and better working arrangements for the reciprocal exchange of information useful for enforcement purposes in the excise tax field would be mutually advantageous to Federal and state administrators. It is recognized that some information is being exchanged, on a highly informal basis, by Federal and state officers working in common areas. This inclination toward friendly cooperation can be further developed. It has been suggested that there might be some economy in the use of investigative officers by arrangements for division of territory and exchange of audit information, but certain practical difficulties that stand in the way have not been resolved thus far. Nevertheless, even if such an approach is not feasible at this time, it would seem that there must be numerous opportunities

for developing cooperation along less formalized lines. There is need for discussion, planning, and experimentation with various types of cooperative working arrangements. The possibilities might well be explored with respect to all sectors of the broad excise tax front.

Coordination of Federal and State Auditing for Income Tax Purposes

Since the individuals and corporations subject to state income taxes are, in the main, also subject to Federal income tax, it follows that there is overlapping of the audit and other enforcement activities of Federal and state authorities. Potentially, the maximum possible overlapping is a high percentage of the common tax base; in practice, however, the actual overlap is likely to be only a small portion of the theoretical maximum. No data are available as to how many income taxpayers have been investigated by both Federal and state examiners for any one tax year.

The idea of coordinated effort is particularly attractive with respect to the income tax field, where there is a common tax base for both Federal and state levies. Thus far, the most successful efforts to that end have been in connection with the exchange of information, as previously discussed. Actual coordination of field audit work has not been achieved. A variety of problems and practical difficulties need to be resolved before large-scale coordination of audit work becomes feasible.

Informal discussions have been held during recent months among representatives of the Bureau of Internal Revenue, state officials, and officers of the National Association of Tax Administrators with a view to attaining some positive coordination of income tax audit work. Although these discussions have been exploratory in character, they have indicated the existence and general location of some promising lines of advance. It is highly desirable that these discussions be continued through the exploratory stage and into the stage of practical experimentation and pilot operations.

COST OF LIVING VARIATIONS AND THE PERSONAL EXEMPTION FROM THE INCOME TAX

SIDNEY BORDEN *

THERE has been little discussion, in this country, of the feasibility of varying the personal exemption from the Federal income tax in conformity with the cost of goods and services in the area in which the taxpayer resides. This paper deals with the theoretical significance of the personal exemption, the differences in intercity and interregional costs as indicated by the available data, and attempts an evaluation of these data as a basis for varying personal exemptions.

Personal Exemptions and the Cost of Minimum Subsistence

Economists have long justified the principle of tax exemptions. The exemption of a minimal amount was consistent with the subsistence cost of labor theory of such early theoreticians as Smith and Ricardo. Otherwise, it may be argued, a tax imposed upon subsistence cost would result either in a decline in the number of workers or in a shifting forward of the tax to consumers through an increase in prices.[1]

The concept of the exemption of a minimum of subsistence was accepted by such writers as John Stuart Mill[2] and Cassell.[3] Bastable argued that exemption was further justified because of the high cost of collecting small amounts of taxes from low-income groups.[4] Seligman believed that taxation of the subsistence minimum would result in starvation, inadequate shelter, and the like or in an increase in public relief expenditures.[5]

The exemption of a minimum amount was opposed by Gustav Cohn, who believed that the tax immunity of a significant segment of the population was dangerous to the financial responsibility of the state, and that the services of the state were as important to the individual as the other basic necessities of life.[6] Taussig also opposed the exemption of subsistence incomes on the basis that the privilege of citizenship should be paid for.[7]

There has been a more general acceptance in recent works of the principle of exemption. Certain public finance

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[1] Cf. discussion by P. J. Strayer, *The Taxation of Small Incomes* (New York: The Ronald Press Co., 1939), pp. 24-25.

[2] John Stuart Mill, *Principles of Political Economy* (new ed.; London: Longmans, Green & Co., 1909), p. 807.

[3] Gustav Cassell, "Theory of Progressive Taxation," *Economic Journal*, December, 1901, pp. 481-491.

[4] George Bastable, *Public Finance* (London: Macmillan & Co., 1892), pp. 295-296.

[5] E. R. A. Seligman, *The Income Tax* (New York: The Macmillan Co., 1911), p. 29.

[6] Gustav Cohn, *System der Finanzwissenschaft* (Stuttgart, 1889), par. 220.

[7] F. A. Taussig, *Principles of Economics* (2d ed.; New York: The Macmillan Co., 1918), vol. II, p. 522.

theorists such as Hobson,[8] Dalton,[9] and Buehler [10] base their position on the deleterious effect of nonexemption on the efficiency or the supply of labor. Others support exemption because of the effect of taxation in raising relief costs,[11] because of the social desirability of an adequate standard of living,[12] and because of the administrative difficulties arising from the imposition of a direct tax on low-income groups.[13] Allen and Brownlee, further, support exemption of a minimum income because it " helps to underwrite the markets for consumer goods and thus the successful operation of our private enterprise system." [14] Arguments similar to the above were adduced in a recent study of exemptions by the Division of Tax Research of the Treasury Department.[15]

It is evident from the review of the theory that the personal exemption found in most income tax legislation is based on the premise that a subsistence minimum should not be taxed. In practice, however, the level of exemption has been varied, not in accordance with any estimate of the minimum cost of living, but in accordance with revenue requirements. The British Royal Commission on the Income Tax in its report of 1920 stated, " the exemption limit has never in this country been based on a figure consciously related to any kind of minimum subsistence. . . ." [16] It is equally true, as Jensen pointed out,[17] that exemptions in the United States have evidenced little relationship to any consideration of the cost of living.[18]

Recent proposals in regard to income tax legislation, however, indicate popular acceptance of the theoretical connection between statutory exemption and some standard or cost of living level. A spokesman for labor, for example, in demanding an increase in the amount of exemption, stated that the then current $500 exemption was " nowhere near sufficient to meet the historical objective of personal income tax exemptions which was to permit a

[8] J. A. Hobson, *Taxation in the New State* (New York: Harcourt, Brace and Howe, 1920), p. 18.

[9] H. Dalton, *Principles of Public Finance* (9th ed.; London: G. Routledge & Sons, 1936), pp. 104-105.

[10] " Taxes on subsistence tend to limit the population and eventually raise wage rates as the supply of workers becomes relatively smaller." A. G. Buehler, *Public Finance* (2d ed.; New York: McGraw Hill Book Co., 1940), p. 392.

[11] Cf. H. M. Groves, *Financing Government* (rev. ed.; New York: Henry Holt and Co., 1946), p. 449.

[12] Cf. W. J. Shultz, *American Public Finance and Taxation* (rev. ed.; New York: Prentice-Hall Inc., 1936), p. 335; cf. also J. P. Jensen, *Government Finance* (New York: Thomas Y. Crowell Co., 1937), pp. 305-306.

[13] Cf. E. D. Allen and O. H. Brownlee, *Economics of Public Finance* (New York: Prentice-Hall Inc., 1947), pp. 293-294; cf. also Shultz, *op. cit.*, p. 335.

[14] *Op. cit.*, pp. 293-294.

[15] U. S. Treasury, Division of Tax Research, *Individual Income Tax Exemptions*, December, 1947, p. vi.

[16] Cited by Strayer, *op. cit.*, p. 31.

[17] *Op. cit.*, p. 306.

[18] Cf. for similar statement M. Newcomer, " The Level of Personal Income Tax Exemptions," in *Tax Exemptions* (New York: Tax Policy League, 1939) p. 94. Cf. however, *Report of Commissioner of Internal Revenue*, 1866, p. xxiii, in which the Commissioner states that the $600 exemption from the Civil War income tax was intended to free the cost of necessities from taxation; cf. also *Congressional Record*, August 28, 1913, p. 3851, for statement that House provision of a $4,000 family exemption from the income tax was based on consideration of a reasonable standard of living for the American family.

family to maintain the necessary minimum standard of living." [19] Similarly, Secretary of the Treasury John W. Snyder stated that " present exemptions which had their origin in the wartime emergency would be too low under peacetime conditions even if there had been no price increases." He went on to say that even an increase in the exemption from $500 to $600 would be "inadequate in the light of the very substantial increase in the cost of living." [20]

TABLE 1

	New Orleans	Washington, D. C.
Income	$3,500	$3,500
Cost of subsistence level of goods and services	2,400	2,762
Balance before personal income tax	1,100	738
Tax	128	128
Surplus above subsistence and tax requirements ..	$ 972	$ 610

There has been tacit acceptance, in our discussion thus far, of the concept of a single exemption level for the entire country. A fixed per capita exemption, however, may give rise to inequities since it does not reflect geographical differences in costs.

As an example, let us take two four-person families resident in New Orleans and Washington, D. C. (the lowest and highest consumer cost areas, respectively, in June, 1947),[21] each with an income of $3,500. The assumption is made that the total personal exemption of $2,400 is equivalent to the cost of a subsistence level of goods and services in New Orleans. The cost of an identical basket of goods and services in Washington in June, 1947, was 15.1 per cent higher, or $2,762.[22] Thus, although the two families received identical incomes and enjoyed the same standard of goods and services, the family living in the low-cost area had a surplus greater by $362 than the other family.[23] (See Table 1.) It should be noted that such a large variation exists only for the extreme cities; cost variations among other cities are less marked. It is suggested that equity might be served if exemptions were varied so as to recognize intercity differences in the cost of an identical standard of living.

The remainder of this paper discusses studies of geographic differences in cost and the possible use of such differences as a basis for adjustments in the personal exemption.

Measurement of Intercity Variations in Cost

Other studies, such as the Treasury publication cited above, indicate the difficulties inherent in the construction of a cost of living index valid for use as a measure of basic living costs in any

[19] U. S. 80th Cong., 1st sess., Senate Committee on Finance, Hearings on H.R. 1, statement by S. H. Ruttenberg, C.I.O., p. 247; cf. also p. 251; *New York Times*, October 17, 1945, reports a demand by the executive council of the A.F. of L. for an increase in the personal exemption because the current level was inadequate owing to the high cost of living.

[20] U. S. 80th Cong., 2d sess., Hearings before the Committee on Ways and Means on H.R. 4790, *Reduction of Individual Income Taxes*, 1948, p. 23.

[21] See Table 2.

[22] The intercity budget estimates for June, 1947, included an estimate of family tax requirements in each of the 34 cities. It was not possible to deduct the Federal income tax from total tax obligations.

[23] This difference would have been more pronounced in any of the previous years since the cost spread of the extreme cities in each other case exceeded 15.1 per cent.

one place. The compilation of such data to portray differences in costs between regions, between cities, and between urban and rural areas presents additional difficulties. It is desirable, first of all, to compare the cost of identical standards of living, that is, to price similar " baskets " of goods and services in the various areas being compared. But, since tastes, customs, and needs differ, the level of costs of a predetermined complex of goods and services may be a poor indication of the cost of subsistence in any given locality. For example, how treat the difference in the need for such items as fuel, outer clothing, and housing between northern and southern cities without adjusting the measurements for different consumption standards? Or how adjust for differences in food preferences? A technique of cost measurement which permits variation in specific items for identical levels of living is needed as a basis for interarea measurements.[24] Problems of the same nature, but of considerably greater magnitude, confronted the International Labour Office in the early 1930's in its effort to compare the costs of identical levels of living in Detroit and in various European cities. To overcome difficulties caused by international differences in consumption habits and customs and to allow for nonstandard items of consumption, without permitting these differences to distort the results, the I.L.O. study suggested that the best results would arise from the use of an " international commission of experts which would have visited each town in turn, [and] would have thoroughly investigated the condition of living . . . ." [25] The evident shortcomings of such a method of operation, and the expense and time involved were recognized. A conspicuous shortcoming is the unsuitability of such a method during periods of rapid price changes.

Studies of Intercity Variations in the Cost of Living

Before 1935 there had been but infrequent efforts to determine intercity and interregional differences in the costs of living in the United States. Perhaps the first of these studies was conducted by the Board of Trade of Great Britain in 1911.[26] An identical food budget, based on the needs of a hypothetical average family, was priced in 28 cities in the United States. Indices of such prices varied from 91 per cent to 108 per cent of the base used, a difference of 19.78 per cent.[27]

In 1928 the National Industrial Conference Board published the results of a survey of the " average minimum cost of maintaining a fair American standard of living " for the four-person family of an industrial worker in twelve industrial communities.[28] Costs

[24] Cf. U. S. Department of Labor, Bureau of Labor Statistics, Bulletin No. 699, *Changes in Cost of Living in Large Cities in the United States, 1913-1941*, 1941, p. 13.

[25] *An International Enquiry into Costs of Living*, Series N, No. 17 (Geneva, 1931) p. 5; cf. also International Labour Office, *International Comparisons of Cost of Living*, Series N, No. 20 (Geneva, 1934).

[26] *Report of an Enquiry by the Board of Trade into Working Class Rents, Housing and Retail Prices . . . in the Principal Industrial Towns of the United States of America* (London 1911) reprinted as U. S. 62nd Cong., 1st sess., Senate Doc. No. 22, 1911.

[27] *Ibid.*, p. xxxiv.

[28] *The Cost of Living in Twelve Industrial Cities* (New York: The Conference Board, 1928).

varied from $1,441.96 in Marion, Ohio, to $1,659.84 in New York City, a difference of 15.11 per cent.

By 1935 there were several continuing series showing variations in living costs over time for different communities. The then existing cost series of the Bureau of Labor Statistics, the Heller Committee of the University of California, and the National Industrial Conference Board, however, were not comparable with each other, and indicated only changes in the cost of a certain basket of goods and services for each of the cities surveyed. In order to compare intercity costs, the Works Progress Administration priced a " cost of living " budget in 59 cities in 1935.[29] The W.P.A. study commented upon the existing lack of data: " Until this study was made . . . data were not available to show how much is required for support at a uniform level of living in a large number of places at the same time, or how these costs compare on an intercity basis." [30]

The budget priced in the 59 cities was based upon the maintenance needs of a four-person family, with the income earner engaged in an industrial, service, or manual occupation. This W.P.A. maintenance budget, by definition, provided for psychological as well as physical needs, although it did not provide for a standard of living as high as that of skilled workers.[31] The W.P.A. priced this budget in March, 1935, and March, 1937. This budget was repriced, subsequently, with some variations in content, at irregular intervals, by the Bureau of Labor Statistics (see Table 2). These modifications in budget content may be disregarded here since it is not the purpose of this paper to discuss the makeup of a minimum budget, but to examine geographic differences in the price of such a budget.

Although the original W.P.A. data contained information on budgetary costs in 59 cities, only those 31 cities have been selected for analysis which were included in subsequent repricings by the Bureau of Labor Statistics.

The earliest study considered, that of March, 1935, indicated a budget cost in the highest-cost city, Washington, some 25 per cent greater than that in the lowest-cost city, Mobile. Despite this significant spread between the extremes, the standard deviation was 4.9 per cent for all cities and 3.8 per cent for the 25 central cities (see Table 2). The spread in costs between the highest and the lowest-cost cities, considered as a percentage of the lower figure, shows a constant narrowing except for the March, 1937, period. In 1947, their spread was but 15.1 per cent. It is interesting to note that while the standard deviation, all cities, increased from 4.9 per cent in 1935 to 5.4 per cent in 1937, the standard deviation calculated for the 25 central cities diminished from 3.8 per cent to 3.7 per cent in the same period. In 1946 the standard deviation, all cities, was 3.5 per cent and standard deviation, 28 cities (3 cities added to the data), was 2.3 per cent. Comparable data for June, 1947, were 3.3 per cent, all cities, and 2.1 per cent, 28 central cities.

[29] M. L. Stecker, *Intercity Differences in Costs of Living in March 1935, 59 Cities*, Research Monograph XII, (Washington, D. C.: Works Progress Administration, 1937).

[30] *Ibid.*, pp. x-xi.

[31] *Ibid.*, p. xviii.

TABLE 2

INTERCITY VARIATIONS IN COST OF SIMILAR GOODS AND SERVICES, 1935-1947

[Average = 100. Number of cities included: 31, March, 1935, to September, 1941; 33, March, 1943; 34, June, 1947. Costs compared are estimated cost of living for four-person manual worker's family. Range and standard deviation calculated from unrounded data.]

City	(1) March 1935	(2) March 1937	(3) June 1939	(4) Sept. 1941	(5) March 1943	(6) March 1946	(7) June 1947
Atlanta	99	100	99	98	98	98	98
Baltimore	101	101	99	99	98	102	101
Birmingham	91	93	94	96	95	101	101
Boston	105	103	105	105	103	103	103
Buffalo	98	98	96	98	98	95	96
Chicago	106	106	107	108	106	102	102
Cincinnati	102	102	98	99	99	98	97
Cleveland	105	106	103	104	104	99	100
Denver	97	98	97	94	95	99	99
Detroit	103	107	105	107	107	102	102
Houston	94	95	97	95	96	92	94
Indianapolis	93	95	95	96	96	97	96
Jacksonville	95	95	96	98	98	97	98
Kansas City	97	97	94	92	93	95	94
Los Angeles	102	103	99	97	98	101	101
Manchester	...	...	...	...	100	98	97
Memphis	95	95	97	97	99	100	100
Milwaukee	...	...	...	...	101	102	103
Minneapolis	108	111	105	104	103	101	102
Mobile	88	86	88	89	89	103	102
New Orleans	96	94	94	96	97	94	93
New York	107	105	110	109	109	103	104
Norfolk	98	96	99	101	102	102	101
Philadelphia	101	101	99	98	98	98	100
Pittsburgh	102	102	101	102	101	101	102
Portland, Me.	99	97	100	99	101	100	100
Portland, Ore.	95	98	99	99	100	100	98
Richmond	99	99	99	98	97	101	100
St. Louis	104	104	102	103	102	103	101
San Francisco	108	106	108	106	108	104	103
Savannah	...	...	...	...	...	99	98
Scranton	102	100	101	101	100	96	98
Seattle	96	98	102	103	102	106	105
Washington, D. C.	110	109	111	109	108	109	108
Range: high-low[a]	25.2	28.0	25.4	22.3	21.7	17.9	15.1
Standard deviation	4.9	5.4	....	....	....	3.5	3.3
Standard deviation, central cities[b]	3.8	3.7	....	....	....	2.3	2.1

Source: Derived from: Columns (1) and (2) M.L. Stecker, *Intercity Differences in Costs of Living in March, 1935, 59 Cities*, W.P.A., Research Monograph XII, 1937, p. 10; column (3) *Monthly Labor Review*, November, 1939, p. 1166; column (4) Bureau of Labor Statistics, *Changes in Cost of Living*, September 15, 1941, p. 18; column (5) *Monthly Labor Review*, October, 1943, pp. 804-05; columns (6) and (7) Bureau of Labor Statistics, *The City Worker's Family Budget*, Serial No. R. 1909, 1948, p. 20.

[a] High-cost city minus low-cost city, expressed as a percentage of low-cost city.

[b] For 25 cities in 1935 and 1937; 28 cities in 1946 and 1947.

There is little doubt that a personal exemption from the Federal income tax adjusted in accordance with local cost levels would bring about greater

equity in income taxation. The data, however, indicate that intercity differences are so small that such adjustments would offer comparatively little relief except to taxpayers resident in the few higher-cost cities.[32] Adding further to the difficulty of making such adjustments is the changing comparative cost level of many cities. Although certain cities such as Washington, D. C., New York, and San Francisco have been consistently high cost, and other cities, such as Houston, Kansas City, and New Orleans have been consistently low cost, other cities have varied significantly in their comparative cost position. Seattle, for example, which at 105 per cent of average cost was second highest in June, 1947, had a percentage cost in March, 1935, of 96 per cent. Similarly, Mobile, the lowest cost city in March, 1935, was above average in costs in June, 1947. Consequently, it is not possible to state of most cities that they are permanently low cost or permanently high cost.[33]

Cost Variations, Northern and Southern Cities

Inspection of the data contained in Table 3 indicates that consumer costs in southern cities are lower, generally, than those in northern cities. There is, however, considerable overlapping. Of the 20 cities classified as northern, living costs in 8 exceeded that in Mobile, the highest-priced southern city.[34]

TABLE 3

RELATIVE COST OF SIMILAR GOODS AND SERVICES, NORTHERN AND SOUTHERN CITIES, JUNE, 1947

(Average, 34 cities = 100)

City	Relative Cost
Southern	
Mobile	102.0
Birmingham	101.2
Norfolk	100.9
Richmond	100.3
Memphis	100.2
Savannah	98.0
Atlanta	98.0
Jacksonville	97.6
Houston	93.6
New Orleans	93.5
Northern	
Washington, D. C.	107.6
New York	104.2
Milwaukee	103.2
Boston	103.0
Detroit	102.5
Pittsburgh	102.4
Chicago	102.1
Minneapolis	102.1
Baltimore	101.5
St. Louis	101.1
Philadelphia	99.7
Cleveland	99.6
Portland, Me.	99.6
Denver	98.6
Scranton	98.4
Manchester	97.5
Cincinnati	97.1
Indianapolis	96.4
Buffalo	96.3
Kansas City	93.7

Source: Table 2.

Small and Large Communities

The B.L.S. data used above deal with consumer costs in the larger cities. Other studies have compared costs of large and small communities. After an examination of fifteen budget investigations, which contrast expendi-

[32] If it is assumed that the data are indicative of cities generally, budgetary costs in some two-thirds of all cities vary no more than 3.3 per cent from the arithemetic mean. The cost in more than 50 per cent of all cities varies less than 2.1 per cent from the mean.

[33] Cf. in this connection, Bureau of Labor Statistics, Bulletin No. 927, *Workers' Budgets in the United States: City Families and Single Persons, 1946 and 1947*, 1948, p. 24.

[34] Cf. *Monthly Labor Review*, October, 1946, p. 533 for similar comparison on basis of March, 1945, data; and *Monthly Labor Review*, July, 1939, pp. 24, 28-29.

tures in large and small urban areas, one study comments: "Contrary to the widely held opinion that living costs are less in small cities and villages than in large cities, variations in living costs among the cities of the same size were found to be greater than between large and small cities." [35]

A study of costs in Kentucky in 1946 revealed that living costs were lowest in and about large cities of the State, while a similar study of Minnesota costs disclosed that these costs were lowest in communities with populations less than 20,000.[36]

The 59 cities examined in the 1935 study of comparative costs were classified by size, and average costs for each size category were obtained. These average costs, expressed as a percentage of the 59-city average, varied from 105.6 per cent in cities of 1,000,000 or greater population to 97.6 per cent in cities of a population size between 25,000 and 100,000 (see Table 4). The highest comparative cost, however, was found in cities of the 500,000 to 1,000,000 population category, while the highest priced individual city was in the 250,000 to 500,000 population class.

Urban and Rural Areas

Since families in rural farm areas receive a large portion of their income in kind, and since most of their noncontractual money expenditures are made in rural nonfarm and in urban areas, no over-all comparison of costs in urban and rural farm areas is available. It is probable, however, that food and housing costs, on the basis of equal standards, are lower in rural areas, while other costs, such as clothing, medical service, and education may be higher.[37]

In general, costs in rural nonfarm areas (communities with populations less than 2,500) are lower than in urban areas. For example, a pricing of a working woman's budget in New York State in September, 1947, indicated a statewide average cost of $1,990 annually, while the cost in rural nonfarm areas included in the study was $1,845, or 7.3 per cent less than the State average. In 1945 and 1946, costs of such a budget in rural nonfarm areas in New York State were less by 7.2 per cent and 6.9 per cent, respectively, than the State averages.[38]

Regional Variations

The W.P.A. study offered the most comprehensive analysis yet made of interregional differences in costs. Of the nine regional classes (see Table 4), costs in the Middle Atlantic states were highest at 103 per cent of the 59-city average, while costs in the East South Central states were lowest at 93.7 per

[35] New York State, Department of Labor, *Studies of Living Costs in Large and Small Communities*, rev. ed., February, 1947, p. 1.

[36] *Ibid.*

[37] Cf. U. S. Department of Agriculture, Miscellaneous Publication No. 653, *How Families Use Their Incomes*, 1948, p. 12, and Miscellaneous Publication No. 520, *Rural Family Spending and Saving in Wartime*, 1943, p. 29.

[38] New York State, Department of Labor, *Cost of Living for Women Workers, New York State, 1947*, 1948, pp. 2, 50-51. Cf. however, Kentucky, Department of Industrial Relations, *Evidence and Information Pertaining to Wages of Women and Minors in Laundry and Dry Cleaning, Hotels and Restaurants, and Other Industries*, 1946, pp. 24-28, and Connecticut, Department of Labor, *An Annual Minimum Budget for Working Women in Connecticut*, 1946, p. ii, for examples of higher costs in rural nonfarm areas.

TABLE 4

COST OF LIVING BY GEOGRAPHIC DIVISIONS AND BY SIZE OF CITY, 59 CITIES, MARCH, 1935

[For four-person manual worker's family]

Geographic Division and Size Class	Comparative Cost 59 City Av.=100	Group Av.	Highest Cost in Group	Lowest Cost in Group
Geographic Division				
Middle Atlantic	103.0	$1,299	$1,375	$1,243
East North Central	102.5	1,292	1,356	1,179
New England	101.7	1,283	1,353	1,245
Pacific	101.2	1,276	1,390	1,222
Mountain	100.9	1,272	1,299	1,243
West North Central	100.2	1,263	1,388	1,131
South Atlantic	99.8	1,258	1,415	1,190
West South Central	94.4	1,190	1,233	1,139
East South Central	93.7	1,181	1,221	1,130
Size Class				
1,000,000 or more	105.6	$1,331	$1,375	$1,298
500,000 to 1,000,000	105.7	1,332	1,390	1,261
250,000 to 500,000	99.3	1,252	1,415	1,169
100,000 to 250,000	98.0	1,235	1,312	1,131
25,000 to 100,000	97.6	1,230	1,299	1,130

Source: M. L. Stecker, *Intercity Differences in Costs of Living in March 1935, 59 Cities,* W.P.A. Research Monograph XII, 1937, p. 8.

cent. There was, however, considerable overlapping of the range of costs in each classification. Any generalization about comparative regional costs of living, therefore, would be subject to many qualifications.

Summary and Conclusions

The personal exemption from the Federal income tax has been justified on the basis of such theoretical and practical concepts as the subsistence cost of labor theory, the effects of exemptions on progressivity in the tax structure, the effect on public welfare costs of nonexemption, the administrative difficulty involved in collecting small sums from low-income groups, and the effect of such exemptions on consumption and investment patterns. From the viewpoint of equity, it would be desirable to vary the personal exemption in accordance with the relative cost of a certain complex of goods and services in the locality in which the taxpayer resides. The spread of costs among most localities is small, however, and the trend points toward further equalization. Consequently, the extra tax burden and the tax savings are unimportant except for the few localities at either end of the array. It is doubtful that the gain in equity would offset the difficulties involved in the formulation of cost data for the entire country and in the administration of the income tax on the basis of such data. The formulation of comparable cost data would be exceptionally difficult because of regional variations in the quality of goods available, because of the changing cost status of localities, and because of the wide variations in costs found in any of the classifications used as a basis of comparison.

THE SECOND SESSION OF THE UNITED NATIONS FISCAL COMMISSION

NATHAN N. GORDON *

IN HIS inaugural address, the President made the observation that for the first time in history humanity possesses the knowledge and skill to relieve the poverty and misery which prevail in many parts of the world. The diffusion of such knowledge and skills is one of the principal tasks of the United Nations. Operating through organs such as the Economic and Social Council and specialized agencies such as the Food and Agricultural Organization, it collects and makes available a vast fund of technical data and skills to the countries requesting them. With respect to matters of public finance, the U.N. operates through the Fiscal Commission, one of nine functional commissions established by the Economic and Social Council.[1]

The Fiscal Commission met at Lake Success, January 10-25, 1949, for its second session. Representatives of fifteen nations came to the session from virtually every region of the world and nearly every type of economy.[2]

The interest of international organizations in problems of public finance runs back for many years, but in the past such interest was centered largely on a limited area—the elimination of double taxation of income and property. In 1920, not long after the creation of the League of Nations, a committee of economists was established to look into the theoretical aspects of double taxation.[3] A number of international conferences were subsequently held on this subject. After the creation of a permanent Fiscal Committee of the League of Nations in 1928, double taxation (and fiscal evasion) continued to hold the center of attention. However, the world depression of the 'thirties stimulated interest in other fiscal problems.[4] Because of the war, that work was never completed by the Fiscal Committee and was bequeathed to its successor for completion.

The Fiscal Commission was established by the Economic and Social Council of the United Nations in

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1 Among the others are the Economic and Employment Commission, the Transportation and Communication Commission, the Statistical Commission, and the Commission on Human Rights.

2 The countries represented on the Commission were: Belgium, China, Colombia, Cuba, Czechoslovakia, France, Lebanon, New Zealand, Pakistan, Poland, Ukranian S.S.R., U.S.S.R., Union of South Africa, United Kingdom, and the U.S.A. In addition there were representatives of specialized agencies, such as the Food and Agricultural Organization, and of accredited nongovernmental organizations such as the National Association of Manufacturers.

3 This group consisted of Seligman, Stamp, Einaudi, and Bruin.

4 For a review of the work of the League of Nations on fiscal problems, see Doc. E/CN. 8/37 (January 5, 1949) issued by the U.N. Economic and Social Council.

October, 1946. Its terms of reference were broad. It was to study and advise the Council in the field of public finance, particularly in its legal, administrative, and technical aspects, and to advise it on the fiscal implications of recommendations made by other commissions in their fields. In addition, the Commission was authorized to assist any member government of the U.N. on public finance matters upon the request of that government.[5]

With this authority, the Fiscal Commission embarked at its first session in May, 1947, upon an ambitious program of activity.[6] The Fiscal Division of the U.N. Secretariat was requested to undertake four main sets of projects. First, it was to bring up to date and to publish certain compilations that were initiated by the League of Nations. Second, it was to collect through a series of questionnaires current data and descriptive material on the fiscal systems of the member nations so as to provide a central source of authoritative information and to facilitate the international exchange of information on recent fiscal developments. Third, the secretariat was requested to arrange for and to provide such technical advice as might be requested by member nations. And finally, it was asked to undertake certain studies, particularly with respect to international tax conventions and the effect of taxation on international trade and investment.[7] In adopting such a program of work, the Commission did so with the realization that it would necessarily extend over several years. The problems associated with the recruitment of staff, and the creation of a well-functioning team, as well as the limits placed upon the size of the staff, made it evident that the program would not be completed in the interval between the first and second session of the Commission.

The second session of the Commission was devoted to a review of the secretariat's achievements in the preceding year and a half, a discussion of a number of proposals by several member governments, and to the establishment of a program of work for the future.

Public Debt and Tax Treaty Publications

The Fiscal Division had been requested to complete two projects which were inaugurated by the Commission's predecessor in the League of Nations. The secretariat brought them to fruition and published two books. One is a volume entitled *Public Debt, 1914-1946* which contains an historical summary of the public debt for fifty-two countries, with breakdowns of long- and short-term debt, domestic and foreign held debt and debt service. For some countries, it also presents details such as interest rate and purpose of issue for major debt obligations contracted since 1928. The other volume is entitled *International Tax Agreements* and reproduces over 100 agree-

[5] Resolution of the Economic and Social Council, October 1, 1946.

[6] Technically, the Commission has no operating staff. However, a Fiscal Division has been created in the secretariat to serve the Commission. This is the only instance where a commission of the Economic and Social Council has a special permanent staff assigned to it.

[7] For a list of the material published by the Fiscal Division of the Secretariat, see Document E/CN. 8/39 Rev. 1 (January 10, 1949) of the Economic and Social Council.

ments concluded since 1936. This volume is a supplement to a series of six volumes previously issued by the League.

The Commission as a body did not undertake an analytical discussion of either volume, although a discussion of the public debt volume might have been particularly useful in guiding future activities. It probably would have brought the Commission to such questions as the following, which are likely to arise from time to time in connection with different projects: Are the data for different countries comparable? If not, should they be published in such a form as to induce comparisons? Is there sufficient qualitative information so that appropriate analyses of the data can be made? What use is to be made of the data? It is to such questions that the Commission will have to address itself for the optimum utilization of its limited resources. The failure of the Commission to discuss the volume, and this applies to other material submitted by the secretariat, was probably due to the inability of the delegates to give it adequate study prior to the meetings.[8]

The publication on tax agreements is merely a collection of documents and did not provoke any detailed discussion. However, in view of the growing interest among nations in bilateral treaties to eliminate double taxation, this volume is likely to be of widespread interest. To facilitate its use among the Latin-American countries, the Commission recommended that it be made available in Spanish in addition to French and English, which are the two working languages of the U.N. It was suggested to the Commission that an effort be made to ascertain which of the agreements are in force and which are not, but this was declared to be a time-consuming task. The staff was therefore requested to ascertain such information only as a by-product of other work.

The interest of member governments in bilateral treaties was repeatedly evident during the session. In addition to making the provisions of existing agreements easily available by publishing them in three languages, the Commission adopted a resolution urging governments that are members of the United Nations "actively [to] pursue a policy of negotiating bilateral agreements wherever possible for the avoidance of double taxation."

Questionnaires to Member Governments

The Commission had requested the staff to collect a large mass of material from member governments relating to the results of their fiscal operations in recent years and the provisions of their tax laws. Subsequently the secretariat sent out a series of questionnaires. One of these was to secure data to establish a Fiscal Information Service for member governments and U.N. agencies. It was designed also to provide data for a public finance survey which the staff has begun. The survey will ultimately consist of a series of pamphlets (one for each country) giving detailed information on revenues, expenditures, and public debt, and an analytical discus-

[8] In this connection it should be noted that the Commission's work was handicapped because the date of the session was advanced by several months. The secretariat had less time than expected to complete its projects and the delegates less time to study them. However, this is less true of the public debt volume than of other staff materials.

sion of the fiscal position of each country. Instead of waiting until it has completed the assembly of data and its analyses, the staff plans to make the results of its work public as it proceeds.

Another questionnaire which the staff had circulated was on administrative practices used in the assessment and collection of taxes. This information is expected to facilitate tax treaty negotiations. One of the provisions frequently found in such treaties calls for the exchange of information and assistance in enforcement of taxes. Hence, a knowledge of the administrative practices of a given country would indicate the kind of information and assistance which it may be expected to provide. It may be of interest in this connection to observe the variation in the type of reply which a given questionnaire may elicit from different governments. On the one hand, the response of New Zealand to the questionnaire on administrative practices consisted of three legal-sized pages explaining the items of tax and income information it secures from taxpayers, the penalities which are imposed to assure compliance, and the enforcement methods used to collect tax. On the other hand, the response of the Union of South Africa consisted of ten lines giving the titles of the administrative authorities and stating that forms are distributed to taxpayers which are filled out by them and are the basis for assessment of tax.

A third questionnaire circulated by the Fiscal Division was aimed at determining the extent to which tax laws discriminate between nationals and foreigners or between domestic transactions and foreign transactions. This subject is currently of great interest to many countries, both exporters and importers of capital. It is part of a broader problem which the staff has begun to study under the heading "Effects of Taxation on International Trade and Investment."

Member governments have been slow to reply to the questionnaires and as a result the progress on these projects has been slow. The Commission therefore adopted a resolution calling on member governments to supply promptly the information requested by the staff.

Technical Assistance

In the formal statement of the scope of activities assigned to the Commission, technical assistance occupies a prominent place. This phase of the staff's work was greeted with great interest, and comments by the delegates, especially from the economically backward countries, indicated that potentially it was among the most useful functions of the Commission.

The secretariat had given technical assistance to Venezuela, Haiti, and Brazil. Special missions were sent to the first two countries for on-the-spot analyses, and, in the case of the last country, a special memorandum had been prepared. The Venezuelan mission was the most extensive. It covered such matters as budgetary forecasting, government accounting, revenue administration, tariff revision, auditing procedures, and such related problems as personnel policy. The mission to Haiti consisted of representatives of various U.N. groups, including the Fiscal Division. Fiscal matters were only part of a broad program of study which included such problems as land use and

commercial policy. The Commission did not discuss the assistance rendered by the secretariat, but, in order that more countries may benefit from the analyses and recommendations made in any particular case, it requested the secretariat to report the substance of its recommendations to the countries receiving technical assistance.

Revision of Agreements to Avoid Double Taxation

After considering the past work of the secretariat, the Commission turned its attention to a series of proposals which had been made by various member governments. Most of these related to issues arising in connection with treaties to eliminate double taxation. One proposal was that the scope of such agreements should be expanded to include social security taxes. Discussion of the proposal revealed it to be impractical because of the wide diversity in methods of financing social security. For example, New Zealand imposes a social security tax which is merely an addition to the income tax and has all the attributes of an income tax. It is therefore a reasonable next step for New Zealand to extend its double taxation treaties to the social security tax. However, the New Zealand social security tax is rather unusual. In most other countries social security taxes are not so closely related to income taxes. Thus, in the United States the larger share of the total social security taxes is in the form of excises imposed on employers. The Commission also rejected the idea of extending the tax treaties to include tax penalties, since they are imposed to assure proper compliance with the tax laws of a country.

Another double taxation problem which the Commission was requested to consider related to differences in the taxation of corporation income. One of the techniques for eliminating double taxation is for one country to allow as a credit against its tax the amount of taxes imposed by another country. This device is appropriate when the two countries impose income taxes of the same kind, but when the taxes are different in character the credit device creates difficulties. In New Zealand corporation income is "fully" taxed (not merely at a standard or first-bracket rate) while dividends are not taxed to the recipient. In the United States, on the other hand, corporations are taxed on their profits and stockholders are taxed on the dividends they receive from corporations. In the one case, corporate profits may be said to be taxed in one step and, in the other, in two steps. If the U.S. stockholder in a New Zealand corporation does not receive a credit for part of the taxes paid by the corporation, he may plausibly argue that he is subject to excessive taxation. A credit to the stockholder on the other hand would be inconsistent with the present dichotomy in the United States between the taxation of corporations and individuals. The Commission was not prepared to offer any solution to the problem and requested the secretariat to explore possible alternatives. Similar action was taken in connection with an estate tax problem in which the issue was the appropriate tax credit in certain double domicile cases.

The Commission also considered a proposal that a special international

tribunal be established to settle disputes arising under tax conventions and that taxpayers should have direct access to international tribunals. Both suggestions were rejected. A special tribunal was held to be unnecessary. Tax conventions generally provide for the settlement of differences by negotiation between the two signatories, and this procedure was regarded as operating satisfactorily. The subsidiary suggestion that an international tribunal entertain petitions from individual taxpayers as well as from governments was held to be inappropriate.

The suggestion was made that a consolidation be undertaken of two model tax conventions—the Mexico (1942) draft and the London (1946) draft—prepared at regional conferences sponsored by the League of Nations. Although the two drafts are similar in many respects, there are some substantial differences between them. Broadly speaking, these differences may be said to reflect the divergent points of view of capital importing countries and capital exporting countries, and it is doubtful that the differences can or should be reconciled. The staff had previously undertaken to secure the comments of member governments on the two drafts with a view to reaching a consolidated version. But many governments have yet to submit their comments, and the staff was requested to continue its efforts to obtain them.

Two nations had suggested increased cooperation between member governments in exchanging information with a view to reducing tax evasion. Cooperation of this kind was accepted by the Commission as an essential part of a tax convention to eliminate double taxation. But there was a difference of opinion as to whether exchange of information should go beyond that necessary to implement such treaties, and the staff was requested to study the question further.

One of the lesser problems which may be created by currency controls is the inability of taxpayers operating in a foreign country to obtain sufficient foreign exchange with which to satisfy their tax liability to their home country. The Fiscal Commission was asked to consider the establishment of special clearing arrangements to meet this problem, but it referred the issue to the International Monetary Fund as the appropriate agency to deal with the problem.

Fiscal Policy Studies

At its first session the Commission was urged to initiate a study of the fiscal policies adopted by governments to prevent depression. The proposal was voted down by the Commission partly because it would require an excessive amount of the resources available to the secretariat and would impose a burden on member governments and partly because such a broad study was believed to be outside the frame of reference of the Fiscal Commission. The Economic and Employment Commission was regarded as the more appropriate agency to initiate such a study. However, interest in the subject continued and manifested itself quite strongly at the second session of the Commission. Representatives of the American Federation of Labor, the Food and Agricultural Organization, the International Chamber of Commerce, and several governments ex-

pressed their support of it. Some of the arguments presented for the fiscal policy study were not very persuasive. One proponent suggested that an attempt be made to ascertain the maximum ratio of tax collections to national income which is consistent with full employment and production. However, the Commission retreated somewhat from its position at the first session and agreed that the staff might undertake some preparatory work on fiscal measures to prevent depression and on the influence of taxation upon standards of living. This was done with the understanding that any elaborate studies by the Fiscal Division would be attempted only at the request of and in cooperation with other U.N. organs.

Trusteeship Report

The Trusteeship Council of the U.N. prepared a draft questionnaire addressed to the administering authorities of trusteeship territories which was designed to elicit a comprehensive report each year on the operations of the territories. The draft was referred to the Fiscal Commission for its comments on the questions dealing with fiscal matters. During the session, a working group was established which reviewed the questionnaire and proposed a number of technical changes which are to be transmitted to the Trusteeship Council.

In the brief period of its existence, the Fiscal Commission has not been able to devote itself to major substantive questions. It has instead been concerned largely with the accumulation of basic information and with the establishment of channels for acquiring such information. These projects are now well under way. At future sessions of the Commission, therefore, it may be expected that substantive issues will receive the attention of the members of the Commission, many of whom are expert in various aspects of government finance, and that the wealth of their combined experience will be directed to the solution of the more pressing fiscal problems confronting the members of the United Nations.

BURDEN OF STATE AND LOCAL TAXES IN 18 LARGE CITIES

RAYMOND E. MANNING *

USING DATA largely supplied by the Bureau of the Census on state and local tax collections, the author applied certain formulas to arrive at estimates of the state and local (county, district, and municipal) tax burdens imposed in each of the eighteen United States cities having a population in excess of 500,000. These figures will be given in terms of the burden per capita and the portion of the total burden per city imposed by each of seven classes of taxes.

The cities for which the computations are made include Baltimore, Boston, Buffalo, Chicago, Cincinnati, Cleveland, Detroit, Los Angeles, Milwaukee, Minneapolis, New Orleans, New York City, Philadelphia, Pittsburgh, St. Louis, San Francisco, Seattle, and Washington, D. C.

In order to compare tax burdens, it is necessary, first, to measure the burden carried in each city and, second, to formulate suitable bases for comparing them. In the process of doing this, various assumptions and procedures were selected which have influenced the final results.

Validity of Assumptions

For the purpose of the computations, it was assumed that all state taxes are borne by the people of the state, and that all municipal taxes are borne by the people of the municipality. These assumptions are obviously of limited validity. For example, the people of the entire country help to pay the stock transfer tax of New York State, the hotel room tax of New York City, and the severance taxes of Louisiana. Racing enthusiasts from the District of Columbia contribute to the pari-mutuel tax imposed by Maryland, and Marylanders increase District tax collections by buying Washington alcoholic beverages and gasoline. Residents of New Jersey working in Philadelphia bear part of the burden of Philadelphia's income tax. To the extent taxes on corporations are passed on to consumers, all the world bears the burdens imposed by Michigan or Detroit on the automobile industry or the burdens imposed by Minnesota on iron mining, by Pennsylvania on the steel industry, or by Massachusetts on the textile industry, and so on.

The assumptions, however, can be justified in a measure, first on the ground that a large part of many of the taxes imposed (for example) by state or city A are borne within state or city A. And second, when they are not so borne, but are passed on to the inhabitants of states and cities B, C, and D, taxes imposed by B, C, and D are in turn passed on to the inhabitants of state or city A, and in the long run these will tend to "even out." This is doubtless true to an undetermined extent.

An important qualification which should be kept in mind when considering the figures in the tables relates to the use of per capita tax burden as the principal base of comparison. This can only be meaningful as the taxes imposed directly or indirectly fall upon the population as a whole and not on a comparatively few. In addition, the per capita burden does not reflect the ability to pay, which may vary sharply from city to city.

* The author is Senior Specialist in Tax and Fiscal Policy of the Legislative Reference Service of the Library of Congress. This article is adapted from material supplied by the author and printed in a report of the House Committee on the District of Columbia, 81st Cong., 1st sess., Report No. 315, *Providing for Additional Revenue for the District of Columbia.* Appendix I of this report gives a summary, city by city, of each state and local tax, the statutory citation, the rate, the dollar amount of burden, and the per capita burden.

Procedures Used

The procedure for estimating burdens, after making these assumptions, was this: The burden of each tax imposed by the states was estimated first on a straight population basis, and, second, according to other formulas. In using the population basis, tax collections were divided by the state population to get a per capita average; this per capita average was then multiplied by the city population to find the city burden of each state tax. Simple addition then established the estimated total burden of all state taxes borne by the city.

In the the case of other formulas, actual collections of state taxes within the city, volume of retail sales, effective buying power of residents, population, automobile registration, etc. were used singly or in combination to determine what percentage of the burden of each state tax is borne within the city. This percentage was multiplied by the state collections from each tax to find the total dollar burden of each tax borne within the city, and this total dollar burden was then divided by the population to determine the per capita burden. Again, simple addition provided the total estimated burden of all state taxes borne by the city.

The burden of county and other district levies was similarly determined, although usually this meant no more than making an allocation according to the ratio of assessed values of property within the city to the total assessed values of property within the entire county or district.

Total collections from municipal taxes were assumed to represent the total burden of municipal taxes. The per capita burden was, of course, found by dividing the collections by the population.

The total burden of state, county, district, and municipal taxes was then determined by adding the results of each of the preceding computations, both as to totals and as to per capita figures.

While the second method of allocating taxes to cities, through use of different formulas, hardly produces scientifically accurate results, it is believed that it presents a more nearly true picture than does an allocation on a straight population basis.

When allocations of state taxes were made on other than a straight population basis, various factors were used. For example, if statistics showed actual collections of state taxes by individual cities (and this was infrequent), these statistics were sometimes accepted as reflecting the burden borne within the city. Other times they were rejected as not truly representative. For example, individual income tax data were accepted, but corporation tax data were rejected because (in the case of the corporation) the burden often more truly falls on widely dispersed stockholders and consumers of the corporation's product.

The factors entering into the formulas have been taken largely from *Sales Management*. These factors have included the volume of retail sales and effective buying power of each city and state. Often these two factors, together with population, provided the ratio for making an allocation. For example, take the case of retail sales taxes. It was felt that the ratio of retail sales within a city to total retail sales within the state would exaggerate the burden of a retail sales tax borne by the inhabitants of the city because cities are so often the shopping center for a suburban or even rural area. It was recognized that a population factor would reduce the exaggeration by too much because of the (usually) larger income of city dwellers, so an effective buying-power ratio was added. Thus in the case of retail-sales taxes, the average of three ratios (retail sales, population, and buying power) was applied to total state-wide collections from the retail-sales tax to determine what part of the total burden is borne by the city.

Similar treatment was accorded corporation, public utility, severance, and unemployment compensation taxes. Population and buying-power ratios were used

TABLE 1

PER CAPITA BURDEN OF STATE AND LOCAL TAXES IN 18 CITIES

City	Taxes, Except Unemployment Compensation Taxes							Unemployment Compensation Taxes	Grand Total
	Property	Income	Death and Gift	Sales and Gross Receipts	Licenses and Permits	Other	Total		
Baltimore	$45.13	$10.42	$1.46	$ 35.52	$ 7.65	$ 0.48	$100.66	$ 7.73	$108.39
Boston	81.20	29.16	2.37	18.49	5.96	.46	137.64	10.09	147.73
Buffalo	63.13	20.98	2.37	24.73	9.28	1.72	122.21	16.05	138.26
Chicago	55.27	....	1.43	41.60	9.79	....	108.09	7.33	115.42
Cincinnati	46.29	....	1.42	41.97	8.79	....	98.47	7.77	106.24
Cleveland	51.28	....	1.42	45.86	10.19	....	108.75	7.73	116.48
Detroit	63.57	....	3.53	49.26	10.15	.16	126.67	13.17	139.84
Los Angeles	61.75	14.48	2.32	61.11	8.63	.07	148.36	14.88	163.24
Milwaukee	62.18	32.47	2.95	18.53	8.88	.03	125.04	5.93	130.97
Minneapolis	56.59	22.87	1.64	30.33	7.74	5.50	124.67	6.03	130.70
New Orleans	29.77	9.47	.72	53.60	9.80	10.89	114.25	7.57	121.82
New York City	56.64	23.47	2.52	36.78	5.79	2.12	127.32	16.40	143.72
Philadelphia	38.99	19.65	2.78	19.90	10.44	.29	92.04	6.40	98.44
Pittsburgh	39.09	7.45	3.78	37.12	12.70	.09	100.23	7.21	107.44
St. Louis	35.38	9.34	1.28	38.51	9.60	....	94.12	7.89	102.02
San Francisco	63.42	17.05	2.64	58.86	5.84	.08	147.89	16.75	164.64
Seattle	33.92	....	1.76	102.85	8.61	.33	147.47	14.04	161.51
Washington, D.C.	47.32	12.88	2.55	16.63	5.68	....	85.05	2.78	87.83
Median	$55.27	$10.42	$2.32	$ 38.51	$ 8.88	$ 0.16	$122.21	$ 7.77	$130.70

for taxes on amusements in general, insurance, and alcoholic beverages. Buying power alone was used for the individual income tax, and population alone for tobacco taxes. Motor-vehicle registrations were used as the base for allocating motor-vehicle and gasoline taxes. Very arbitrary apportionments were made for horse-racing taxes (after giving consideration to location of tracks) and to taxes on boxing and wrestling. In all cases, where other information was available which would help in making an intelligent apportionment, it was used even though similar information was not available for other states or cities.

Sources of Data

Data on state tax collections were derived almost exclusively from the work sheets of the Governments Division, Bureau of the Census, which were used by the Division in publishing its *State Tax Collections in 1948.*[1] Most of the data were for fiscal years ending in 1948 (June 30 or earlier). Data on municipal tax collections were also taken from the work sheets of the same Division which are currently being used to compile the 1947 report on Large City Finances.[2] Data on county and district taxes were taken from official reports and from *Moody's Governments and Municipals.*[3] Most of the data on cities, counties, etc. are for the calendar year 1947 because most cities operate on a calendar year fiscal basis, though there are exceptions.

[1] U. S. Bureau of the Census, *State Tax Collections in 1948* (State Finances: 1948, No. 4), Washington, D. C., August, 1948, 10 pp.

[2] Cf. U. S. Bureau of Census, *Large-City Finances in 1946* (City Finances: 1946, No. 3), Washington, D. C., December, 1947, 56 pp.

[3] Moody's Investors Service, *Governments and Municipals, 1498;* and semiweekly supplements.

TABLE 2

Percentage of Total State and Local Tax Burden Raised from Each Type of Tax in 18 Cities

City	Taxes, Except Unemployment Compensation Taxes							Unemployment Compensation Taxes	Grand Total
	Property	Income	Death and Gift	Sales and Gross Receipts	Licenses and Permits	Other	Total		
Baltimore	41.64	9.61	1.35	32.77	7.06	0.44	92.87	7.13	100.00
Boston	54.97	19.74	1.60	12.52	4.03	.31	93.17	6.83	100.00
Buffalo	45.66	15.17	1.71	17.89	6.71	1.24	88.39	11.61	100.00
Chicago	47.89	....	1.24	36.04	8.48	...	93.65	6.35	100.00
Cincinnati	43.57	....	1.34	39.50	8.27	...	92.69	7.31	100.00
Cleveland	44.02	....	1.22	39.37	8.75	...	93.36	6.64	100.00
Detroit	45.46	....	2.52	35.23	7.26	.11	90.58	9.42	100.00
Los Angeles	37.83	8.87	1.42	37.44	5.29	.04	90.88	9.12	100.00
Milwaukee	47.48	24.79	2.25	14.15	6.78	.02	95.47	4.53	100.00
Minneapolis	43.30	17.50	1.25	23.21	5.92	4.21	95.39	4.61	100.00
New Orleans	24.44	7.77	.59	44.00	8.04	8.94	93.79	6.21	100.00
New York City	39.41	16.33	1.75	25.59	4.03	1.48	88.59	11.41	100.00
Philadelphia	39.67	19.96	2.82	20.22	10.61	.29	93.50	6.50	100.00
Pittsburgh	36.38	6.93	3.52	34.55	11.82	.08	93.29	6.71	100.00
St. Louis	34.68	9.16	1.25	37.75	9.41	...	92.26	7.74	100.00
San Francisco	38.52	10.36	1.60	35.75	3.55	.05	89.83	10.17	100.00
Seattle	21.00	....	1.09	63.68	5.33	.20	91.31	8.69	100.00
Washington, D. C.	53.87	14.66	2.90	18.93	6.47	...	96.83	3.17	100.00
Median	41.64	9.16	1.42	35.23	7.06	0.11	92.87	7.13	100.00

Summary figures therefore often represent a combination of figures compiled for separate fiscal periods. Unsatisfactory though this may be, there is hardly any alternative.

Results

Tables 1 and 2 summarize the results obtained through use of the different allocation formulas.[4] It may be helpful to list in more detail just what taxes are included within each of the table headings. Briefly they are as follows:

Property taxes: All taxes on real and personal property, including intangible property.

Income taxes: All taxes on or measured by net income, including income of individuals, corporations, and (where taxable) unincorporated business.

Death and gift taxes: Inheritance, estate, and gift taxes.

Sales and gross receipts taxes: General retail sales, gross income taxes, selective sales taxes on tobacco, alcoholic beverages, gasoline, and other products and services, gross receipts taxes on public utilities, premiums taxes on insurance companies, admission taxes, taxes on pari-mutuels, etc.

Licenses and permits: License fees, privilege taxes, permits, corporation taxes (when not measured by income), incorporation fees, motor vehicle registration, and other fees.

Unemployment compensation taxes: State levies for paying unemployment compensation.

Other: Severance, poll, documentary, and all other taxes not fitting into the preceding categories.

Washington, D. C., A Case in Point

We have tried to keep the limitations of the report before the reader. Since these factors are especially important in the case of Washington, D. C., we shall discuss the

[4] Tables showing the allocation of tax burdens on a straight population basis are included in House Report No. 315, *op. cit.*, pp. 16-17.

pertinency of our procedures and assumptions to this city and qualify our results.

The most important conclusion to be drawn from the statistics, so far as the burden of taxation can be measured on a per capita basis, is that they show that the people of the District of Columbia bear a lighter tax than do the inhabitants of other large cities. The lowness of this burden results in large measure from low per capita sales and gross receipts taxes, the low individual income tax of restricted application, and the extensive employer exemption (Federal Government) from unemployment compensation taxes. A second conclusion of importance is that on this basis of measurement the District has second place in the proportionate part of all taxes which is raised by taxes on property, and may in fact actually have first place.

There is one important way, however, in which the tax burden borne by the people of the District of Columbia may actually be higher than the statistics show. This stems from the fact that the people of the District are essentially consumers of goods rather than producers. Thus the "evening out" process noted above will not be present. The people of the District will bear part of the burden attributed in the tabulations to other cities but which in fact is passed on to the ultimate consumer (including the District resident), while there is no correspondingly great shift beyond District lines of District taxes, except on the tourist trade, because so few interstate goods are produced.

There is also a way in which a per capita dollar amount fails to show an advantage possessed by the people of the District. It is the fact that as a group they possess a higher income (ability to pay) than the residents of most other cities; this advantage, however, is tempered by the higher cost of living.

Property Taxes.—The District per capita burden of property taxes on a dollar basis is neither exceptionally high nor low comparatively, although it is below the median. But the percentage of property tax collections to total tax collections is the highest of any city, except Boston. There is one important particular (which the statistics cannot show) which exaggerates the burden on the residents of other cities in contrast to the District. The tax burden of 235,000 Federal employees in the District does not reflect any taxes on their place of employment; namely, the tax-exempt Government building. Possibly comparable to the property taxes paid by the steel mill or the factory in other cities is the Federal contribution to the District, amounting in fiscal year 1948 to \$12,000,000. This would equal \$14.39 per capita to be added to the District burden.

Income Taxes.—The District is about average so far as the burden of income taxes is concerned for states and cities imposing such taxes, but one comment seems called for. Because of the type of District individual income tax imposed which exempts so many thousands of Government employees claiming a "domicile" elsewhere, the income-tax burden falls solely on "permanent" residents, while a large segment of the population completely escapes. Still a further point is that many of the persons claiming and securing an exemption from the District tax will actually pay an income tax to the state in which they claim legal domicile. This will have the effect of raising the revenues of their "home" state and the computed average burden of that state, while at the same time lowering the computed average of the District of Columbia where they are counted for population purposes.

Death and Gift Taxes.—The District stands at the top so far as the burden of death and gift taxes is concerned. The amount involved, however, is comparatively small and may vary substantially from year

to year. Except in the interest of showing the complete statistical picture these taxes might well be omitted from any computation of tax burdens since they apply to so few persons during the course of a year.

Sales and Gross Receipts Taxes.—As pointed out above, the per capita burden imposed in the form of sales and gross receipts is lower in the District than anywhere else. This lowness is the more striking because of the fact (which the statistics do not reflect) that many Maryland and Virginia residents buy gasoline and alcoholic beverages in the District owing to the lower tax rate, thus boosting the low level which would otherwise be even lower. Countering this somewhat is the fact that many District residents contribute to the retail sales tax of Maryland and to the heavily taxed pari-mutuel pools in Maryland.

Unemployment Compensation Taxes.—It is not altogether clear that contributions by employers to unemployment compensation funds should be included at all in computations of this kind. However, they have been included here for purposes of completeness. To the extent that these contributions are reflected in the price of goods sold, the statistics understate the tax burden of the people of the District. The reason is that while the tax receipts come only from a small segment of private employers, the per capita burden is arrived at by dividing this amount by total population, including Government employees. District residents in buying goods in interstate commerce indirectly pay the taxes hidden in the price of goods so purchased, while there is no correspondingly great shifting of taxes paid to the District.

STATE TAXATION OF PRODUCTION OF BLENDED SPIRITS

ORBA F. TRAYLOR *

THE FOLLOWING comments are concerned with whether blended spirits production should be exempt from a state whiskey-production tax. Although Kentucky is the only state now imposing a whiskey-production tax, any whiskey-producing state contemplating such a tax must decide whether to tax the blending of whiskies as well as the distilling of straight-bourbon and straight-rye whiskies. Resolving this tax question is conditioned in part on the fact that a switch in consumption from straight to blended liquors has occurred during the war and postwar years. The present discussion centered on the Kentucky experience although certain implications are drawn for the other major bourbon-producing states of Illinois, Indiana, and Ohio and the major rye-producing states of Maryland and Pennsylvania.

The Kentucky Whiskey-Production Tax

Kentucky's whiskey-production tax, in effect since 1934, is 5 cents per proof gallon on distilled spirits produced in the State. A tax of 5 cents per gallon is also levied on spirits imported into the State. No tax is imposed on blending, rectifying, or mixing of distilled spirits provided the production tax has been paid on the component spirits.[1] Thus no additional tax is paid for rectification where whiskey and neutral spirits comprise the blend if the whiskey-production tax has been paid previously on the component spirits. Blends of straight whiskies of varying ages and proofs bear the full original 5 cents per proof gallon tax, but no further tax is required.

The Kentucky whiskey-production tax of 1934 was levied primarily with the straight-whiskey distillers in view.

* The author is assistant professor of economics and business, University of Missouri. The material presented here is a summary of a portion of a study made during the summer of 1948 as consultant to the Kentucky Department of Revenue. The views presented do no reflect the official opinion of the Kentucky Department of Revenue. The author acknowledges the assistance of the Research Council of the University of Missouri in making a grant of funds.

[1] Kentucky, *Laws*, 1934, chap. 149. In prepro-hibition times, the Kentucky distiller of straight whiskies went virtually untaxed except for low occupational licenses and personal property taxes. The rectifier in Kentucky, however, besides these two types of taxes encountered in 1904 a special occupational license tax the rates of which were based on the quantity rectified or compounded (50 cents per barrel and 25 cents per package less than one barrel). This rectifier tax was the first Kentucky occupational license graduated by gallonage distilled. *Ibid.*, 1904, chap. 104. In 1906, an additional rectifier tax was levied of 1.25 cents per wine gallon of single-stamp spirits (blended whiskies) which were rectified, blended, or adulterated. *Ibid.*, 1906, chap. 87. In *Brown-Forman Company* v. *Commonwealth of Kentucky*, 125 Ky. 402 (1907), the 1906 tax was held applicable to rectified spirits made from double-stamp spirits (straight whiskies) and to constitute an additional occupational license tax on rectifiers distinguishable from property tax. On pre-prohibition analogy, it was this 1906 rectifier tax which was extended and made applicable to distillers of straight whiskies by the whiskey-production tax of 1934. Orba F. Traylor, *Taxation of Distilled Spirits in Kentucky and other States*, unpublished doctoral dissertation (Lexington, Kentucky: University of Kentucky, 1948), pp. 115-31.

As blending operations in Kentucky have increased considerable efforts have been exerted by the Kentucky blenders to obtain complete exemption. During the 'thirties, the Kentucky blenders took the position that using Kentucky straight spirits on which the production tax had been paid made the costs of bottling blends in Kentucky about 12 to 13.5 cents more per case than in Illinois, Indiana, Maryland, or Pennsylvania.[2] It was asserted that these added costs could not have been justified had it not been for the large initial plant investments already committed in Kentucky. The Kentucky whiskey used in a blend loses its identity since no mention of it appears on the label of the blended whiskey. The chief argument for complete exemption was that the whiskey-production tax hindered blending operations and prevented Kentucky from taking over a larger percentage of the national whiskey market. The Kentucky blenders contended that the total market could be expanded without lessening the demand for the straight-bourbon product in which Kentucky had national pre-eminence.[3] A subsidiary contention was that, unless exemption were granted for Kentucky whiskies used in blends, Kentucky blenders would import the bulk of whiskies used from outside Kentucky. The State would lose revenue because the import tax would be paid on the reguage rather than on the original gallonage. Also, Kentucky personal property taxes could be avoided by timing imports to allow withdrawal of whiskies as needed for rectifying.

The 1940 Kentucky General Assembly rejected the claims of the Kentucky blenders for exemption of component whiskies of blended spirits from the State whiskey-production tax.[4]

Other State Whiskey-Production Taxes

The 1901 Missouri whiskey-production tax of 10 cents per gallon applied not only to straight spirits but also to production of blended spirits, brandy, rum, and gin.[5] Before the 1936 Maryland whiskey-production tax was reduced from 5 cents to 2.5 cents per proof gallon in 1937, rectifying activity was subject to the full tax. In 1937, the manufacture of neutral spirits and brandy was specifically exempted; and in 1939, the Maryland whiskey-production tax in its entirety was repealed.[6] From 1935-1941, Arkansas

[2] Joseph E. Seagram and Sons, Inc., *The History of the Development of Whiskey* (1940).

[3] Letter of Mr. H. F. Willkie, Joseph E. Seagram and Sons, Inc., January 4, 1940.

[4] The contentions are to be found in *Brief on House Bill No. 356;* submitted to the 1940 Kentucky General Assembly by Mr. T. N. Taylor and Mr. J. T. Woodward on behalf of Mr. Joseph Padway, counsel of the American Federation of Labor; *About House Bill No. 356*, Kentucky General Assembly, 1940; and Joseph E. Seagram and Sons, Inc., *New Fields to Conquer* (1940).

[5] Missouri, *Laws*, 1901, p. 227. Following repeal of the tax in 1909 (*ibid.*, 1909, p. 656) no appreciable revival of straight-whiskey distilling occurred.

[6] Maryland, *Acts*, 1936, ex. sess., chap. 10; 1937, reg. sess., chap. 23; 1939, reg sess., chap 277. Promotion of neutral spirits distilling was partly the motivation for exempting neutral spirits and brandy in 1937, although the major concern in reducing the tax rate was over the depressed state of straight-rye distilling. The repeal of the tax on straight-whiskey distilling in 1939 was actually ill-timed, insofar as Maryland's whiskey-tax revenues were concerned, since Pennsylvania, Maryland's chief straight-rye competitor, offered no real competition as a straight-rye producer. Pennsylvania, however, was providing Maryland considerable competition in the production of neutral spirits so that a division in types of production between Maryland and Pennsylvania developed similar to that between Kentucky and its major-bourbon competitors in Illinois and Indiana.

TABLE 1

RATIOS OF BLENDED TO STRAIGHT-WHISKEY PRODUCTION BY STATES, 1935-1947 [a]

(In per cent)

Year	Ky.	Ill.	Ind.	Ohio	Md.	Penna.
1935	2.5	8.6	23.4	4.1	13.8	13.3
1936	1.3	5.7	15.8	6.8	20.1	22.3
1937	0.5	5.3	19.9	4.6	32.9	25.8
1938	3.5	4.8	25.8	3.9	30.5	20.3
1939	6.0	4.5	24.2	4.5	38.0	21.5
1940	10.6	5.4	21.5	3.0	26.2	20.4
1941	10.8	6.1	20.2	2.8	26.0	21.1
1942	10.8	29.3	95.1	38.4	163.0	103.1
1943	62.6	360.3	1,947.5	942.6	1,822.3	504.3
1945	117.5	294.4	384.5	1,519.7	312.9	200.6
1946	46.3	106.8	113.7	670.9	148.9	61.4
1947	36.9	107.5	124.1	585.6	113.2	95.9

Source: Derived from *Annual Reports of the Commissioner of Internal Revenue*, United States Treasury Department.

[a] Fiscal years ending June 30. No beverage whiskey was produced in fiscal year 1944.

levied a whiskey-production excise tax of 5 cents, which applied to the production of blended spirits in the same way as the Kentucky tax.[7]

Rectifying Production

The data on gallonage rectified show rather clearly that Kentucky, despite its production tax, has increased its output of blended whiskies. In 1941, whiskey rectified in Kentucky approximated 4 million proof gallons; in 1947, around 32 million gallons were rectified. Table 1 gives the ratio of blended-whiskey production to straight-whiskey production in the major producing states.

Market for Whiskies

Withdrawals are ordinarily considered an approximate measure of market possibilities and suggest liquor consumption trends.

In Kentucky, the withdrawals of both bottled-in-bond and rectified spirits are increasing as compared with barrel withdrawals of straight-bourbon whiskies. In 1947, total Kentucky withdrawals were divided as follows: 75 per cent, rectified spirits; 17 per cent, bottled-in-bond whiskies; 8 per cent, straight-bourbon whiskies. In 1938, these percentages were 22 per cent, 21 per cent, and 57 per cent respectively. Apparently, the Kentucky whiskey-production tax has had no strong adverse effect on rectifying.

Within the bourbon-producing area of Kentucky, Illinois, Indiana, and Ohio, rectified withdrawals in 1947 show Illinois to be a strong competitor of Kentucky. Nevertheless, the percentages of rectified to total withdrawals in 1947 were 56 per cent, 37 per cent, 6 per cent, and 2 per cent for Kentucky, Illinois, Indiana, and Ohio respectively. These percentages in 1938 were 9 per cent, 13 per cent, 68 per cent, and 10 per cent respectively. In 1947, Kentucky accounted for 56 per cent of the bourbon withdrawals, 92 per cent of the bottled-in-bond withdrawals, and 41 per cent of rectified withdrawals of the bourbon-producing area. Apparently, Kentucky's gain in rectifying

[7] Arkansas, *Laws*, 1935, chap. 158, sec. 14174; 1941, Act no. 266, sec. 6. There is no record of any distilleries in operation in the State.

has not been at the expense of its interests in straight-bourbon and bottled-in-bond whiskey markets of the bourbon-producing area. Table 2 shows how the bourbon-producing states are sharing their market.

TABLE 2

State Withdrawals of Three Types of Whiskey, Bourbon-Producing Area, 1936-41, 1942-47

(In percentages of total area withdrawals of each type)

Years and Types	Ky.	Ill.	Ind.	Ohio
1936-1941				
Bourbon	41.4	37.1	14.6	7.0
Bottled-in-bond ..	72.9	13.1	9.0	5.0
Rectified	17.7	14.0	58.4	10.0
1942-1947				
Bourbon	47.1	30.4	10.7	8.3
Bottled-in-bond ..	80.0	11.5	6.3	2.6
Rectified	36.1	23.9	30.7	8.6

Source: Derived from *Annual Reports of the Commissioner of Internal Revenue*, United States Treasury Department.

In the national whiskey market, rectified-spirits withdrawals rose from approximately 32 per cent to 36 per cent of the total over the period 1937-1941 and from 41 per cent to 81 per cent over the period 1942-1947. The straight-whiskey market for both bourbon and rye whiskies declined 1937-1947, while rectified spirits increased from 33 per cent of the total in the period 1937-1941 to 63 per cent in the period 1942-1947. Bottled - in - bond withdrawals increased in the 1937-1941 period but decreased in the 1942-1947 period.

Table 3 indicates how the major whiskey-producing states are sharing the national whiskey market for blended spirits. Kentucky distillers are accounting for the largest withdrawals. All of these states for the 1941-1947 period continue their smaller withdrawals of straight-bourbon and rye whiskies and of bottled-in-bond whiskies.

Other Rectifying Activity

Kentucky tax-paid withdrawals of alcohol (the form found in alcoholic beverages is known as ethyl alcohol) show the trickle prior to 1945 increasing thereafter to significant levels. Kentucky production, however, is still below that of the other major whiskey-producing states.[8] The amount of alcohol used by Kentucky blenders in rectification is appreciably greater than Kentucky production, indicating that Kentucky has been importing from outside the State. The restrictive effect of Kentucky's production tax is more apparent on scrutinizing the relatively insignificant production record for gin, cordials, and liqueurs produced by rectification.[9] One can hardly assume, however, that the tax is the only factor or the main factor accounting for this.

Kentucky's Import Tax on Distilled Spirits

The purpose of Kentucky's distilled spirits import tax, requiring import permits and payment of a tax equivalent in amount to the domestic whiskey-production tax of 5 cents per proof gallon, is to protect the position of the domestic distiller paying the whiskey-production tax. Kentucky distillers, however, point out that this purpose is not fully accomplished since, because of evaporation, the base of the import tax is only about 60 per cent

[8] *Statistics on Alcohol*, 1934-1947, Alcohol Tax Unit, Bureau of Internal Revenue, United States Treasury Department.

[9] *Annual Reports of the Commissioner of Internal Revenue*, 1935-1947, United States Treasury Department.

as great as the base of the whiskey-production tax. Where title to the imported whiskey has not passed, the Kentucky Department of Revenue does not require payment of the import tax in the event of repossession or purchase back. Some further discrimination is possibly worked against the domestic straight-bourbon distiller in the event of repossession or purchase back where title has passed without discovery of such by the Kentucky Department of Revenue. The amount of evasion is not known but is presumed not to be large.

The Kentucky import tax collections rose consistently 1934-1941, despite the burden of the tax, and rose greatly 1942-1947.[10] Nevertheless, comparison of the revenue yields of the import and production taxes shows the predominance of the latter.[11] The average ratio of import taxes to the total of both types of tax collections was about 5 per cent 1935-1941 and has never exceeded 1 per cent since 1942. Even had the Kentucky production tax completely exempted rectified spirits, there would have been little gain in revenues from import tax collections since very little correlation is found between the amount of whiskey imported and production of rectified whiskey.

TABLE 3

RECTIFIED WHISKEY WITHDRAWALS, BY SELECTED STATES, 1937-1947 [a]

(In percentages of all United States whiskey withdrawals)

Year	Ky.	Ill.	Ind.	Ohio	Md.	Penna.
1937	0.2	1.9	7.0	1.6	11.7	9.1
1938	1.3	1.8	9.6	1.4	11.3	7.6
1939	2.2	1.6	8.8	1.6	10.2	7.8
1940	3.9	2.0	7.9	1.3	9.6	7.5
1941	4.4	2.6	8.3	1.1	10.7	8.7
1942	5.7	4.9	11.6	1.3	10.0	7.7
1943	6.9	6.0	10.5	1.2	10.4	10.3
1944	10.3	8.5	15.0	2.9	11.0	11.8
1945	17.3	12.4	11.9	3.3	8.8	14.7
1946	20.7	12.0	12.6	5.8	10.3	15.3
1947	22.0	12.4	14.4	5.2	12.4	15.0

Source: Derived from *Annual Reports of the Commissioner of Internal Revenue*, United States Treasury Department.

[a] Fiscal years ending June 30.

Conclusions

Any whiskey-producing state contemplating a whiskey-production tax should design its tax to apply equally to the distilling of straight spirits and the rectifying of blended spirits, or neither type of distilling should be taxed on a production basis. The special taxation of the production of whiskey of both types is discriminatory taxation in that the production of other types of goods is not specially taxed. To tax only one type of distilling activity is to make a discriminatory type of taxation even more discriminatory. If the principle of taxing the production of whiskey is sound, consideration may be given to the extension of the produc-

[10] Appendices to *Twenty-Seventh, Twenty-Eighth* and *Twenty-Ninth Annual Reports, 1944-45, 1945-46, 1946-47*, Kentucky Department of Revenue, Frankfort, Kentucky.

[11] Maryland's exemption of blended spirits from its production tax in 1937 evidently stimulated its import tax yields. Joseph E. Seagram and Sons, Inc., *Kentucky Taxes: Their effect Upon the Distilling Industry of Kentucky* (1939), p. 10.

tion tax to all types of manufacturing and industrial activities.

The available evidence reveals that blended spirits have absorbed a larger proportion of the whiskey market at the expense of straight whiskies. Kentucky distillers have engaged in considerable rectifying without lessening their domination of the straight-whiskey market. It is possible to surmise that there has been a permanent change in the type of beverage consumed, but this is by no means certain. The liquor market as between straight and blended whiskies has been decidedly competitive. Whether blended whiskies will continue to comprise even 70 per cent of the total whiskey market, as was the case in 1917, remains to be seen.[13] When normal supplies of all types of whiskies are again available, it is possible that rectification in Kentucky will return to the situation of the early 'thirties when blending operations were somewhat restricted by the Kentucky whiskey-production tax. The 1947 situation is perhaps explainable by a change in consumer tastes as related to adjustment of the distilling industry in a period when straight-bonded whiskies were in short supply. Apparently, the 5 cents a gallon whiskey-production tax has not been a great impediment to either straight-whiskey distilling or blending in Kentucky when traffic in either has increased.

[13] In 1917, straight whiskies amounted to about 60 million gallons out of a total whiskey production of nearly 300 million gallons. H. F. Willkie, *Beverage Spirits in America—A Brief History* (New York: American Branch of Newcomen Society of England, 1947), p. 26.

BOOK REVIEWS

Taxation of Manufacturing in the South. By JAMES W. MARTIN and GLENN D. MORROW. University, Alabama: Bureau of Public Administration, University of Alabama, 1948. Pp. 110.

The principal conclusion reached in this study is that state and local taxation in the southern states is generally favorable to manufacturing. Although manufacturing is advancing more rapidly in the South than in the nation as a whole, there is little or no correlation between tax loads and their distribution and rates of manufacturing growth. Some of the states experiencing the most rapid industrial development have relatively heavy tax loads, but in others taxes are comparatively light.

In preparing this study, the authors had the co-operation of students of taxation in eleven states—in addition to Kentucky. This procedure would seem almost ideal for a regional study. The research reports submitted were doubtless invaluable in developing the analysis of tax differentials. The chapter on "Differential Taxation of Manufacturing" and the later discussion of relative industrial tax loads are excellent.

Ten of the fourteen southern states provide for the temporary exemption of manufacturing plants and equipment, usually for a period of five years. These exemptions are generally restricted to new plants and expansion of existing plants. In eight states there are constitutional provisions relating to manufacturing exemptions. In most states the exemptions are limited to all or specified local levies, but in some states they extend to both state and local property taxes. The authors do not regard the temporary exemption of manufacturing plants and equipment with favor. Two factors are emphasized: (1) There is abundant evidence that "such exemptions do not bulk large in plant location and development"; and (2) "cities sorely need the revenue now sacrificed through the tax subsidy." Experience suggests the "revision of existing statutes by withdrawing statutory exemption authorizations or by requiring a referendum as a condition of exemption."

Differential taxation of manufacturing, the authors point out, is not restricted to property taxes. For example, defective apportionment formulas and unsatisfactory administration of allocation provisions may result in discrimination in income taxation. Interstate businesses may become the victims of double taxation or the beneficiaries of nontaxation, with respect to a portion of their incomes.

Tax administration in the South is appraised in a chapter that is both comprehensive and informative. The point is made that if administration is impartial and effective, tax loads are eased; industry is able to anticipate its tax liabilities. The discussion is rather general in character, with appropriate references to manufacturing. The end result is probably more satisfactory than if only problems encountered by tax officials in their dealings with manufacturers had been considered. Data showing variations in ratios of assessed values to sales values are presented, but they do not relate specifically to manufacturing. It is suggested, however, that "small-scale manufacturers may expect to pay relatively heavier property taxes than large competitors."

Trends in tax collections are analyzed, with a view to discerning their implications for manufacturing. This part of the study is not so well done. Major reliance is placed on a form of statistical presentation

not generally deemed acceptable. Proportions of combined state and local taxes derived from various sources were obtained for 1932 and 1942, and percentage increases or decreases were then computed from the percentage distributions. Figures for tax collections are not shown, though there are frequent references to per capita taxes. Percentage changes based upon percentage distributions are at best confusing; tables such as that for individual income taxes (page 62) may be misleading. Moreover, trends for the decade 1932-42 are discussed as though the 1942 data were reasonably current. Since 1945 state and local finances have been undergoing continuous adjustments to postwar conditions. There have been sharp increases in state and local taxes and—in many states—marked changes in the distribution by tax sources.

This volume impresses the reviewer as distinctly worth while. There is a real need for regional studies of this kind. Their value is enhanced when certain characteristics in taxation are common to an entire area—as in the South. One may hope that similar studies for other regions will soon provide comparable information as to how manufacturing fares under state and local tax laws.

Lewis H. Kimmel
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The State Property Tax in Texas. By Lynn F. Anderson. (The Bureau of Municipal Research, The University of Texas, Municipal Studies No. 33, 1948.) Austin, Texas, 1948. Pp. vii + 132. $1.00.

The property tax long since has lost rank among the prime sources of state income. During the past twenty-five years or so, the majority of states either have turned entirely to alternative forms or have gradually modified the ad valorem levy until it has come to bear slight resemblance to the simon-pure *general* property tax. The de-rating of intangibles, or of all types of personalty, restriction of the state levy to centrally-assessed properties, and gradual reduction in rate are typical of the innovations adopted since the trend toward major reliance upon excises and income taxation began.

Not so in Texas, however, where, despite a gradual decline in the *relative* importance of the general property tax among all State sources, and the prospect of a further drop after next year, its current yield remains at or near peak levels attained in the past. Its basic characteristics, moreover, entitle the Texas tax to status among the last-remaining state *general* property taxes; the homestead-exemption feature stands, perhaps, as the sole deviation from the classical form.

In this useful monograph the author subjects to critical examination the salient features of his State's ad valorem levy. There is a familiar ring to much of the presentation, a sobering reminder that of all present-day revenue devices, the property tax perhaps is handicapped more than any other by parsimonious provision for operation and enforcement, antiquated administrative machinery, and outmoded statutory framework. Assessment performed by inexperienced, part-time personnel; *de facto* exemption of intangibles; regression in the assessment of real estate; legislative lenience toward the delinquent; collection vested in tax "receivers"; confusing division of jurisdiction between central and local assessing authorities; flagrant disregard of statutory valuation standards—all are common attributes of administrative performance and structural arrangements affecting the property tax in this country. Nor is this sorry state of affairs the fruit of any neglect by students and practitioners in the field, for proposals calculated to eliminate or at least to mitigate the shortcomings of our traditional practices and institutional framework are legion. And, moreover, they are in essential agreement on fundamentals.

Positive recommendations made in the present work (pp. 106-26) seem to rest on some such premises as these: (1) the task of local assessment should rest with qualified, adequately compensated officers, employed full time the year around, appointed to office if possible, but otherwise elected for a term of not less than four years, and aided by staff personnel recruited on merit and provided with position classification, promotion on ability, in-service training, and reasonable salary scale; (2) it is a proper state responsibility to exercise positive over-all supervision of the assessment process and to extend technical aid to local officers; (3) equalization of local values by a state agency is vital if intercounty and interclass assessment uniformity is to be attained; (4) direct assessment by a state agency is desirable in respect of public utility property; (5) collection needs to be performed aggressively by duly responsible public officials, equipped with express authority for resort to *in rem* rather than *ad personam* proceedings in foreclosure and a method of seizure-and-sale of real property, and backed by a statute inflicting suitable penalties for nonpayment while affording with rarity any forgiveness for past delinquency; and (6) codification of tax statutes is highly desirable in order to strip them of useless verbiage, and to set out in the clearest possible language and order the essentials of the law.

Most will endorse these objectives as axiomatic in almost any context, as they would the author's somewhat more explicit prescriptions for Texas. Some, however, might quail at the author's tacit acceptance of full-rate taxation on intangibles. The reviewer, however, believes this an experiment (the term is used deliberately) worth trying. On the one hand it could alleviate appreciably the pressure upon real property (albeit that this seems somewhat exaggerated in much current discussion), while on the other hand it might speed the day of statutory and constitutional revision permissive of outright classification.

Texas experience has interesting implications for the not uncommon argument that a state abandoning the ad valorem tax as a significant source of income should nonetheless maintain a sort of token rate to "justify" its concern with assessment standards and equalization and its direct valuation of utility property. While there are other more meaningful arguments for state supervision and control—e.g., the reliance upon aid formulae and debt and tax-rate limits predicated on (uniform) assessed valuations, the need for equitable taxation of assessments made by separate authorities though subject to a common rate, etc.—these, in the popular mind, are less persuasive reasons for "state-house interevention" than the fact, if it can be cited, that the state, too, makes a levy that must be fairly apportioned. Yet, Texas, itself relying heavily upon the general property tax as an important source of State revenue, has provided only a minimal program of direct assistance and supervision and lacks entirely any machinery for State equalization of local values. One may justifiably speculate that the prospects for successful revision in that commonwealth would dim appreciably were the State government to abandon the field entirely to the local units.

A minor disappointment in the present study is its treatment of assessment dispersion. It is not clear from the context (pp. 82-95, esp. Table X, p. 95) whether the discussion of prevailing assessment levels relates to professed or objectively ascertained ratios. The reviewer's inference, however, is that the author has confined himself to the former, i.e., the fractions at which the county assessors *claim* to be listing property. The introduction at this point of documentation in the form of selling price-assessed value analyses would have strengthened the presentation considerably.

LYNN A. STILES

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Major Tax Problems of 1948. Proceedings of the Tax Institute, University of Southern California School of Law. Edited by Louis M. Brown. New York: Prentice-Hall, Inc., 1949. Pp. x + 452. $10.75.

The lawyer or accountant cannot afford to allow his college diploma to become his professional tombstone if he is at all considerate of the welfare of his clients and himself. He must continue to study to be well informed. No subject other than taxation more convincingly bears out the truth of this statement. The conscientious find the field of taxes particularly challenging because it is rather technical and is always in flux. The University of Southern California has joined the ranks of others in conducting a symposium on this subject and in publishing the proceedings.

The opening chapter of this volume is an address by Secretary of the Treasury John W. Snyder on the trials and tribulations of collecting the Government's revenue. The concluding chapter is by W. A. Sutherland, the former Chairman of the Tax Section of the American Bar Association, on the role of the lawyer in the tax field. Another chapter is "Important Differences between Federal and State Taxation" by F. M. Keesling. These three chapters are general discourses on public finance and political theory.

There are four chapters that are of special concern to community-property states and to California in particular. They are "Property Settlement Agreements in Community Property States" by A. H. Kent; "Tax Effects of the Taking of Title by Husband and Wife" by J. W. Ervin; "Income Tax Problems in Oil Transactions—the Carried Interest" by S. D. Krystal; and "Armortization of Motion Pictures" by D. Tannenbaum. These titles are self-explanatory.

In the field of estates and gifts, the book contains three scholarly articles which reflect the current Revenue Act of 1948 with its new concept of the marital deduction. They are: "Drafting a Testamentary Trust under the Revenue Act of 1948" by W. L. Nossaman; "Preparation of Estate and Gift Tax Returns" by E. H. Conley; and "Selected Income Tax Problems in the Administration of Estates" by A. Y. Bennion.

These chapters are followed by two that deal with the problem of leveling off taxable income so as to escape current high surtax brackets. They are "Recent Developments in the Assignment of Income" by D. Latham and "Income Taxes and Deferred Compensation Agreements" by H. J. Rudick.

The next chapter is an abbreviated seminar on a host of tax problems that concern proprietorships, partnerships, and corporations. It treats such subjects as unreasonable corporate earnings, avoidance of double tax, gain on liquidation, death of a partner, and the comparative tax advantages of these three types of businesses. The book also contains a chapter on an allied subject involving tax aspects of buying and selling a business.

Another abbreviated seminar prepared in a similar fashion deals with the tax consequences of life insurance for business purposes.

There are two chapters of limited interest but which are none the less authoritative and informative for those who need this advice. One is on the history of alimony by A. Manella and the other is on corporate reorganizations by T. N. Tarleau. Both authors make much of the abuse to which the Internal Revenue Code has been subjected by the courts with respect to their respective subjects.

Two closing chapters should be of interest to all tax practitioners although for diametrically different reasons. The one on "Settlement Procedures in the Technical Staff and Division Counsel's Office" by B. H. Neblett, a Division Counsel of the Technical Staff in the Bureau of Internal Revenue, is a discussion by a tax lawyer's

adversary of the settling of tax issues with the Treasury in the pre-trial stage. The other chapter is of interest because a former Treasury fraud attorney, A. Groman, discloses how best to protect what remaining rights a defrauding taxpayer has, which is of special value even to the seasoned tax practitioner.

There are few if any business transactions that do not have their peculiar tax aspects. This book as a whole is an authoritative compendium of the Federal tax law on many current business problems. Each chapter is written by a recognized specialist. The lawyer, accountant, and businessman, no matter what the extent of his tax knowledge, should find this volume a valuable and handy storehouse of tax knowledge.

J. H. LANDMAN

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Statistics of Income for 1946, Part 2. (Preliminary report of corporation income tax returns and corporation excess profits tax returns filed through December 31, 1947.) U.S. Treasury Department, Bureau of Internal Revenue. Washington: Government Printing Office, 1949. Pp. v + 21. 10 cents.

This preliminary report, dated April 15, 1949, contains summary data from corporation income tax returns for calendar year 1946 and for fiscal years ending July, 1946-June, 1947, and from excess profits tax returns for fiscal years ending July-November, 1946. It also includes certain part-year returns. The data thus reflect the effect of the Revenue Act of 1945.

Data are shown, by major industrial groups, on number of returns, total compiled receipts, net income or deficit, total tax, income tax, excess profits tax, and dividends paid. There is also a table on dividends received from domestic corporations and interest received on Government obligations. The statistics are compiled from returns as filed, and do not reflect changes due to audit, carry-backs, relief under section 722, recomputation of amortization of emergency facilities, or renegotiation of war contracts after filing. The effects of renegotiation will be shown in a special tabulation to be included in the complete *Statistics of Income* when published.

Public Debt, 1914-1946. (Department of Economic Affairs, United Nations.) Lake Success: United Nations Publications, Sales Number 1948.XVI.1, 1948. Pp. 159. $2.50.

Started by the League of Nations and completed by the United Nations, this book is a compilation of public debt information for fifty-two countries from 1914-1946. It is composed entirely of tables which present data relating to total public debt, domestic long-term and short-term debt, foreign debt, interest and redemption payments, wholesale prices and cost of living index numbers, and the value of U.S. dollars expressed in terms of each country's currency.

Official publications of the fifty-two governments were used as the source of reference for the gathering of material. In a general explanatory note, it is pointed out that in drawing international comparisons, account should be taken of the fact that the different countries employed a variety of budgetary and accounting practices and public debt concepts.

NTA NOTES

FORTY-SECOND ANNUAL TAX CONFERENCE

PLANS for the Forty-second Annual Tax Conference in Boston on September 19 to 22, 1949, are beginning to crystallize, and a large and successful assemblage seems well assured.

The Program Committee, consisting of Chairman C. Emory Glander, Ohio Tax Commissioner; C. Lowell Harriss, of Columbia University; Henry F. Long, Massachusetts Commissioner of Corporations and Taxation; Charles P. McKeon, Tax Attorney and Assistant Secretary of The California Company; H. Clyde Reeves, Kentucky Commissioner of Revenue; Dan Throop Smith, of the Harvard University Graduate School of Business Administration; G. Howard Spaeth, Minnesota Tax Commissioner; and William H. Stauffer, Director of Research for the Virginia State Chamber of Commerce, has made good progress. It is too early to describe the sessions in detail, but it appears that the program will be well diversified, with a considerable emphasis on the effects of taxation upon business. Among the headline speakers at the eight general and six round-table sessions tentatively planned is Mr. Thomas J. Lynch, General Counsel of the United States Treasury Department, who has agreed to speak on the ever-present problem of intergovernmental fiscal relations.

Commissioner Henry F. Long, Chairman of the Local Arrangements Committee, is arranging an attractive entertainment program, featuring a series of trips to historic spots in and around Boston. Without having committed himself until he has had further opportunity to canvass the situation, he mentions Plymouth, Salem, Marblehead, Gloucester, Newburyport, Lexington, and Concord outside Boston and Faneuil Hall, Old North Church, Bunker Hill, Harvard University, and the old State House within the city or immediately adjacent to it. Both delegates and their wives will be afforded opportunities to participate in these instructive and entertaining excursions. Other events are being planned especially for the ladies.

Ample accomodations are assured us in the headquarters hotel, the Statler, at rates which are now quoted as follows:

Singles	\$ 4.50-\$10.00
Doubles for two	8.00- 12.50
Twins for two	10.00- 16.00
Suites for one	17.00- 23.00
Suites for two	20.00- 20.00
Extra beds in doubles or twins	\$2.50 each

Hotel reservations should be made through D. B. Stanbro, Manager of the Statler, Park Square at Arlington Street, Boston 17.

Notice of the Annual Meeting of the National Tax Association

Pursuant to the provisions of Section 1 of Article III of the By-laws, notice is hereby given of the annual meeting of the National Tax Association at the Hotel Statler, Boston, Massachusetts, September 22, 1949, at 2 o'clock P.M. Officers, three regular members of the executive committee, two honorary members of the executive committee, and any additional members required to fill vacancies will be elected at that time.

RONALD B. WELCH
Secretary

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